Texas Margin Tax: Cost of Goods Sold

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A franchise tax is imposed on each taxable entity that does business in Texas or that is chartered or organized in Texas.

Tex. Tax §171.001(a)
**Historic Rates:**

- For retailers and wholesalers, tax is 0.5% of taxable margin.
- For others, tax is 1.0% of taxable margin.

**2015 Rates:**

- House Bill 500 authorized “temporary permissive rates” for 2015. The retailer and wholesaler rate is reduced to 0.475% and the rate for all others is reduced to 0.95%

**Effective January 1, 2016:**

- House Bill 32 cuts the rates of the margin tax by 25%. The retailer and wholesaler rate is further reduced to 0.375% and the rate for all others is further reduced to 0.75%.

Tex. Tax §171.002
Currently:

- Available for a taxable entity with total revenue from entire business ≤ $10 million.
- Total Revenue Apportioned to Texas x 0.575% = Tax
- No credit, deductions (including COGS) or other adjustments.

Effective January 1, 2016:

- House Bill 32 reduces the tax rate to 0.331% and extends the availability of the “E-Z” rate to business with up to $20 million in total revenue.

Tex. Tax §171.1016
No Tax Due If:

- Amount of tax computed for the entity < $1,000
  OR
- Total revenue from entire business ≤ $1,000,000*

* Though $1,000,000 is statutory, the number is tied to the Consumer Price Index and is adjusted based on that fluctuation. For 2014 and 2015, the threshold is $1,080,000.

Tex. Tax §171.002
• Tax due = Taxable Margin x Tax Rate

• Taxable Margin = Apportioned Margin – any other allowable deduction

• Apportioned Margin = Margin properly apportioned to Texas

• Margin is calculated in one of four ways:

Tex. Tax §171.101
Margin Is The Lesser Of:

- 70 percent of the entity’s total revenue from its entire business (default)

OR

- Total revenue from entire business – $1,000,000

OR

- Total revenue from entire business – compensation (if elected)

OR

- Total revenue from entire business – cost of goods sold (if elected)

Tex. Tax §171.101
• Election between COGS and compensation can be made annually.

• Historically, per 34 TAC §3.584(d)(1) and 34 TAC §3.588(c)(3), election could not be changed on an amended return.

   BUT . . .

Tex. Tax §171.101(d)
Comptroller Has Revised Its Policy And Amended The Rules

- Taxpayers now are allowed to amend reports:
  - To change election between COGS and compensation.
  - To elect to use COGS or compensation.
  - To switch from E-Z computation or No-Tax-Due to long form electing COGS or compensation.

- Amended reports may be filed for any period within statute of limitations. Election also can be changed on audit.

34 TAC §3.588(c)(3)
• Change in position is particularly helpful to taxpayers who elected COGS but did not qualify because they do not:

  (i) sell

  (ii) tangible property in ordinary course of business.
• Taxpayers have always been (and still are) able to change from COGS or compensation to 70% of total revenue or E-Z computation (if eligible) on an amended return.

34 TAC §3.584(d)(1)
Cost Of Goods Sold

- All direct costs of acquiring, producing, constructing, installing, manufacturing, developing, mining, extracting, improving, creating, raising, or growing goods.

AND

- Certain costs of maintaining goods.

Tex. Tax §171.1012
**Goods** = real or tangible personal property sold in the ordinary course of business.

- Includes the husbandry of animals;
- Includes growing and harvesting of crops;
- Includes computer programs;
- Includes severance of timber from realty; and
- Includes films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound for which it is intended or reasonably likely that any medium in which the property is embodied will be mass distributed.
- Does NOT include intangible property.

Generally, a taxable entity in the service industry will not have COGS.

Tex. Tax §171.1012
34 TAC §3.588(b)(3)

• Tangible personal property as defined in Tex. Tax Code Ann. § 171.1012(a)(3)(A)(i) includes a film distributor's exhibitions of films, which means these exhibitions fall within the definition of goods contained in § 171.1012(a)(1), and therefore AMC was entitled to subtract its exhibition expenses as a cost of goods sold.

• “Tangible personal property” (“TPP”) includes personal property that can be “seen” or “that is perceptible to the senses in any other manner,” and a movie screening can be seen and is otherwise perceptible to the senses.

• No “take-home” requirement for TPP. In other words, purchaser need not take possession or title to the item.

(cont’d)

• Motion for Rehearing and for Reconsideration En Banc filed July 5, 2015.

• Comptroller has warned this could lead to an annual margin tax loss of $1.5 billion and refunds potentially totaling $6 billion.

• Implications:
  – Potential expansion of the availability of a cost of goods sold deduction to taxpayers who have previously been considered service providers and/or sellers of intangible personal property.
  – Taxpayers previously considered service providers seeking to claim themselves producers of TPP may subject themselves to sales tax liability.
Exception To “Sold” Requirement

- Motor vehicle leasing companies, heavy construction rental or leasing companies, and railcar rolling stock rental or leasing companies may be able to figure COGS based on tangible personal property rented or leased in the ordinary course of business.

Tex. Tax §171.1012
34 TAC §3.588(b)(3)

• CCGVeritas is a geo-sciences company that produces and collects seismic data. It maintains a library of this data and licenses it to the oil and gas industry for the purpose of informing drilling operations.

• CCGVeritas claimed that it furnishes materials and labor when producing its seismic data and is entitled to deduct its cost of goods sold.

• The Court agreed, holding that the seismic data produced by CCGVeritas constitutes “tangible personal property” that qualifies as a “good” licensed to customers in its ordinary course of business, and that CCGVeritas was entitled to fully deduct its cost of goods sold.

• The dispute is currently pending before the Third Court of Appeals.
“Mixed Transactions”

• Contain elements of a sale of tangible personal property and a sale of services.
  – Oil change services (oil and filters vs. labor)
  – Crop duster (chemicals vs. plane fuel, labor, plane rental)
  – Veterinary services (pharmaceuticals vs. labor and fees)

• Only costs that otherwise constitute COGS are included in COGS. Labor and other costs related to service component are not included in COGS.

34 TAC §3.588(c)(7)
Comptroller COGS FAQ #20

Autohaus both sells and services automobiles. On its margin tax return, it claimed a cost of goods sold deduction for the labor costs associated with the service and installation aspect of its business, claiming it “produced” the goods as defined by statute.

The Texas Tax Code defines “production” to include “installation.” The Comptroller’s Rules define “production” much more narrowly to include “installation occurring during the manufacturing or construction process.”

The Court, in finding Autohaus entitled to its cost of goods sold deduction, found the Comptroller's Rule improperly defined “production” more narrowly than did the statute and therefore found the Comptroller’s definition invalid and unconstitutional.

The dispute is currently pending before the Third Court of Appeals.
Examples Of COGS (Direct Costs Of Acquiring Or Producing Goods)

- Cost of materials that are an integral part of goods;
- Labor costs;
- Cost of materials consumed in ordinary course of production activities;
- Handling (e.g., processing, assembling, repackaging, and inbound transportation);
- Storage costs;
- Depreciation, depletion, and amortization reported on federal income tax return to extent associated with and necessary for the production of goods;
- Cost of renting or leasing equipment, facilities, or real property directly used for the producing of goods (includes intangible drilling and dry hole costs);

(cont’d)
Examples Of COGS (Direct Costs Of Acquiring Or Producing Goods)

- Cost of repairing and maintaining equipment, facilities, or real property directly used for the production of the goods;
- Research, experimental, engineering, and design costs (including those described in I.R.C. §174) directly related to the production of the goods;
- Geological and geophysical costs incurred to identify and locate property that has the potential to produce minerals;
- Taxes paid in relation to acquiring or producing any material or in relation to services that are a direct cost of production;
- The cost of producing or acquiring electricity sold; and
- In limited circumstances, a contribution used to fund activities to a partnership in which the entity owns an interest and would otherwise be treated as a cost of goods sold.

Tex. Tax §171.1012(c)
Labor Costs As Direct Costs Of Acquiring Or Producing Goods

- All direct labor costs, including W-2 wages, amounts reported as non-employee compensation on IRS Form 1099, temporary labor expenses, payroll taxes, pension contributions, and employee benefits expenses including, but not limited to, health insurance and per diem reimbursements are included in COGS.

- Taxable entities that calculate their margin using the compensation deduction are not allowed to include compensation reported on IRS Form 1099 or payroll taxes.

34 TAC §3.588
Expansion Of Definition Of “Labor Costs” (Old Rule)

- Historically, the Comptroller only allowed a COGS deduction for “direct” labor costs, meaning wages and benefits paid to individuals who physically produced or acquired goods. The Comptroller took the position that supervisory labor was an “indirect” labor cost, because supervisors did not actually touch the goods.

- Accordingly, supervisory labor was includible in COGS as an indirect or administrative overhead cost and was subject to a four percent cap under 34 TAC 3.588(f).
Expansion Of Definition Of “Labor Costs” (New Rule)

• Under the revised rule, costs includible in COGS as labor costs include:
  – Direct labor costs (labor costs for individuals who touch the goods)
  – Indirect labor costs (labor costs other than “service” costs that can be directly attributed to production or resale activities).

• Labor costs for production supervisors or project managers are examples of indirect labor costs.
Expansion Of Definition Of “Labor Costs” (New Rule)

• The new approach is based on I.R.C. §263A, which requires taxpayers to capitalize into inventory both direct labor and materials costs and certain indirect costs that “directly benefit, or are incurred by reason of, the performance of production or resale activities.”

• For COGS purposes, a taxpayer may treat costs that are of the type subject to capitalization as direct labor costs for federal income tax purposes without regard to whether the taxpayer is required to or actually does capitalize such costs for federal income tax purposes.
“Service Costs” As Labor Costs

• The Comptroller has amended 34 TAC §3.588, to create a category of “service costs:”
  
  – Indirect costs and administrative overhead costs that can be identified specifically with a service department or function, or that directly benefit or are incurred by reason of a service department or function. A service department includes personnel, accounting, data processing, security, legal, and other similar departments.

• All service costs are “indirect or administrative overhead costs” subject to allocation under 34 TAC §3.588(f).

• Service costs that are allocable to the acquisition or production of goods are includible in COGS, subject to a cap of 4 percent of the taxpayer’s total indirect and administrative overhead costs.
Subcontractor Payments As Direct Costs Of Acquiring Or Producing Goods

- A contractor’s payments to subcontractors for the construction, improvement, remodeling, repair, or industrial maintenance of real property may be included in COGS, UNLESS the payment has been excluded from gross revenue as flow-through funds.

Tex. Tax §171.1011(g)(3)
Tex. Tax §171.1012
Comptroller FAQ COGS #8
Depreciation As A Direct Cost Of Acquiring Or Producing Goods

- Depreciation deductions consistent with federal tax reporting are allowable.
- But, federal bonus depreciation is not allowable as part of the COGS deduction.
- Texas statutes and rules are based on the Internal Revenue Code of 1986 in effect for the federal tax year beginning January 1, 2007 (not including any changes made by federal law after that date) and any regulations adopted under that Code applicable to that period.
- Texas does not conform to the Economic Stimulus Act of 2008, which introduced the current bonus depredation rules.

Tex. Tax §171.0001(9)
Texas Policy Letter Ruling No. 200810219L (October 9, 2008)
Capitalization vs. Expensing

- A taxable entity that has a cost of goods sold and that is subject to I.R.C. §263A, §460, or §471 may capitalize that cost in the same manner it capitalized the cost on its federal income tax return or may expense that cost.

See Comptroller’s COGS FAQ #12
Capitalization vs. Expensing: Consistency With Federal Income Tax Reporting

- Elect to capitalize allowable costs for COGS, must capitalize all allowable costs if capitalized for FIT purposes.
- Allowable costs that were not capitalized for FIT purposes must be expensed.
- Costs not allowed in COGS may not be included in COGS even if capitalized for FIT purposes.
- Entity that elects to capitalize allowable costs on its first margin tax report may only include in beginning inventory allowable costs that would be in beginning inventory for FIT purposes.
- Costs in beginning inventory for FIT purposes that are not allowable costs for COGS may not be included in beginning inventory.

See Comptroller’s COGS FAQ #13, 14
I.R.C. §179 Expenses


• After 2009, I.R.C. §179 in effect on January 1, 2007 sets the I.R.C. §179 expense at $25,000 and the property acquisition threshold at $200,000.
## I.R.C. §179 Expense Deduction

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Comptroller COGS FAQ #24
Capitalization vs. Expensing Rules Prevent A Doubling Effect

- **Change from Capitalizing to Expensing:** If the entity first elects to capitalize and later elects to expense costs, it may not deduct any cost incurred before the first day of the report period on which tax is based, including ending inventory from a previous report.

- **Change from Expensing to Capitalizing:** If an entity elects to expense costs and then elects to capitalize costs, a cost expensed on a previous report may not be capitalized.

  Tex. Tax §171.1012(g)
Open Question: Anti-Doubling Rules

• If the entity elects to expense costs, a cost incurred before the first day of the period on which the report is based may not be subtracted as a cost of goods sold.

• As SBOT Tax Section points out, it's not clear whether those costs incurred in prior periods are lost forever or still are available to deduct on a later report if the taxpayer switches to capitalizing costs.
Example:

- Taxpayer buys a $15 million machine that will be depreciated ratably over 15 years.
- Taxpayer capitalizes costs during Years 1-5 ($1 million COGS expense per year).
- Taxpayer elects to expense costs for Years 6-10.
- Taxpayer elects to capitalize costs again in Year 11.

Will Taxpayer be able to capitalize any costs related to the machine for Years 11-15? If so, will the entity be able to deduct:

- $1 million per year over the remaining useful life; or
- $2 million per year (the $10 million of costs yet to be capitalized spread over the remaining useful life)?
Examples Of COGS (Certain Costs Of Maintaining Goods)

- Costs of deterioration of goods;
- Costs of obsolescence of goods;
- Costs of spoilage and abandonment of goods, including rework labor, reclamation, and scrap;
- Preproduction direct costs allocable to property held for future production;
- Post production direct costs, including storage and handling;
- Cost of insurance on a plant or a facility, machinery, equipment, or materials directly used in the production of goods;
- Cost of insurance on produced goods;
- Cost of utilities directly used in the production of goods;
- Costs of quality control, including replacement of defective components, and inspection, repair, and maintenance of the goods; and
- Licensing or franchise costs, including fees incurred in securing the right to use trademarks, procedures, recipes, or similar rights directly associated with the goods.

Tex. Tax §171.1012(d)
Indirect, Administrative, Overhead Costs

- Security services;
- Legal services;
- Data processing services;
- Accounting services;
- Personnel operations; and
- General financial planning and financial management costs.

Are deductible if they are allocable to the acquisition or production of goods.

Capped at four percent (4%) of the taxable entity's total indirect or administrative overhead costs.

Tex. Tax §171.1012(f)
COGS Does NOT Include:

- Cost of renting or leasing equipment, facilities, or real property that is not used for the production of goods;
- Selling costs, including employee expenses related to sales;
- Distribution costs, including outbound transportation costs;
- Advertising costs;
- Idle facility expense;
- Rehandling costs;
- Contract bidding costs (whether bidding is successful or not);
- Interest, including interest on debt incurred or continued during the production period to finance the production of the goods;
- Income taxes and franchise taxes assessed based on income;
- Strike expenses;
- Officer’s compensation (What is an “officer?”);
- Cost of operating a facility on property of the federal government used to house members of the armed forces; and
- Compensation paid to an undocumented worker.

Tex. Tax. §171.1012(e)
Related Party Rule

- A payment made by one member of an affiliated group to another member of the group not included in the combined report may be included in COGS only if the transaction is made at arm's length.

- "Arm's length" is the standard of conduct under which entities that are not related parties and that have substantially equal bargaining power, each acting in his own interest, would negotiate or carry out in a particular transaction.

Tex. Tax §171.1012(l)
34 TAC §3.588(b)(1)
Ownership of Goods Required

• An entity may subtract a cost of goods sold only if it owns the goods.
  – Based on all facts and circumstances.
  – Consider benefits and burdens of ownership.
  – Entity that furnishes labor or materials to a project for construction, improvement, remodeling, repair, or industrial maintenance of real property is considered to be the owner of the labor or materials. The entity may include the costs in the computation of COGS.
  – An entity is treated as the owner of goods being manufactured or produced by the entity under a contract with the federal government notwithstanding that title or risk of loss with respect to those goods may be transferred to the federal government before manufacture or production is complete.

Tex. Tax §171.0102(i)
Titan Trans., LP v. Combs, 433 S.W. 3d 625 (Tex. App.—Austin 2014)

• Petition for Review was denied by the Texas Supreme Court on May 1, 2015.

• **Exclusion of Flow-Through Funds**
  – Tex. Tax §171.1011(g)(3) permits a taxpayer to exclude from total revenue flow-through funds paid for “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.”

• Titan, an aggregate hauler, claimed that it was entitled to exclude subcontracting payments from total revenue as flow-through funds as permitted by the statute. The Comptroller disagreed, but Titan prevailed on its position before the Third Court of Appeals.

(cont’d)
Titan Trans., LP v. Combs, 433 S.W. 3d 625 (Tex. App.—Austin 2014)

- Based on the Comptroller’s historical policy, to be excludable from total revenue or claimed as a COGS deduction, payments had to relate to activities that result in physical change to real property.

- After Titan, the Comptroller revised its policy. “Physical change” was no longer required. “Reasonable nexus” is sufficient. The revised policy applies explicitly to both flow-through funds and a COGS deduction. See Letter 201406920L (June 10, 2014).

- Under the revised policy, subcontracting payments that qualify as flow-through funds may be excluded if they “have a reasonable nexus to the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of boundaries of real property.”
Internal Memo 201504069L (April 23, 2015)

• Revises the Comptroller's existing policy.

• A taxable entity that is eligible for a cost of goods sold deduction and contracts out the manufacturing of the goods is now permitted to claim, as a cost of goods sold, all research, experimental, engineering, and design activity costs, including all research or experimental expenditures described in I.R.C. § 174.

• Under prior Comptroller policy, an entity had to produce the goods at issue to qualify for the deduction.
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