

The Comptroller of Public Accounts proposes amendments to §3.588, concerning margin: cost of goods sold. The comptroller is amending the section to implement House Bill 4002, 85th Legislature, 2017, and House Bill 500, 83rd Legislature, 2013. The changes also add definitions and interpret ambiguous statutory language.

The comptroller amends subsection (a) to indicate that specific provisions of this section apply to reports other than those originally due on or after January 1, 2008.

The comptroller amends subsection (b)(7), defining the term "production," to delete the phrase "installation occurring during the manufacturing or construction process." This deletion implements House Bill 4002, 85th Legislature, 2017, which amended Tax Code, §171.1012(a)(2) (Determination of Cost of Goods Sold) to delete the term "installation" from the statutory definition of "production." The definition in this section now tracks the definition in the statute.

The comptroller amends subsection (c) to add new paragraph (8) concerning movie theaters. New paragraph (8) implements House Bill 500, Section 10, which enacted Tax Code, §171.1012(t), effective September 1, 2013. The language in this paragraph mirrors the statutory language. Subsequent paragraphs are renumbered accordingly.

The comptroller amends renumbered paragraph (9), concerning the ownership of goods, to define several additional terms that are used in the current subsection and to refine the procedure for determining when a taxable entity is the owner of goods for purposes of the cost of goods sold deduction.

Paragraph (9) is reorganized to add new subparagraph (A). Existing language for determining when a taxable entity is the owner of goods is located in new subparagraph (A). The comptroller amends the existing language to state that legal title is the primary consideration in making this

determination. If legal title cannot be determined, then the comptroller will consider the facts and circumstances, including the various benefits and burdens of ownership vested with the taxable entity. Subsequent subparagraphs are relettered.

The comptroller amends relettered subparagraph (B) to define the terms "labor," "material," and "project." Tax Code, §171.1012(i) provides that a taxable entity "furnishing labor and materials to a project" is considered to be the owner of the labor and materials and may include the costs as allowed by §171.1012 in the computation of cost of goods sold. However, the Tax Code does not define "labor," "materials," or "project," and the comptroller has not previously defined those terms in this section. The lack of definitions has created uncertainty and generated numerous controversies. To resolve this ambiguity, the comptroller proposes to add definitions of "labor" and "materials" based on Texas Property Code, Chapter 53 (Mechanic's, Contractor's, or Materialman's Lien), which also uses the terms "labor" and "materials." Because the phrases "furnishing labor and materials" and "furnishes labor and materials" are used in the two statutes, it is reasonable to assume that the Legislature intended similar definitions.

The proposed amendment uses the definitions of "labor" and "material" verbatim from Property Code, §53.001 (3) and (4) (Definitions), except that the proposed amendment replaces the term "work" with the term "project." The definition of "project" tracks the language of Tax Code, §171.1012(i).

Because of the similarity of the statutes, the comptroller will consider caselaw interpreting Property Code, Chapter 53, but may adapt Property Code interpretations to conform to needs of the Tax Code.

The comptroller amends subsection (c) to add new paragraph (10) concerning pipeline entities. New paragraph (10) implements House Bill 500, Section 9, which enacted Tax Code,

§171.1012(k-2) and (k-3), concerning pipeline entities. The language in paragraph (10) mirrors the statutory language. Subsequent paragraphs are renumbered accordingly.

The comptroller amends renumbered paragraph (11) concerning rentals and leases. To better distinguish this provision from subsection (d)(7) of this section, the phrase "rental or leasing companies" replaces the phrase "rentals and leases."

Additional amendments interpret ambiguous statutory language. Tax Code, §171.1012(k-1) provides that motor vehicle rental or leasing companies, heavy construction equipment rental or leasing companies, and railcar rolling stock rental or leasing companies may subtract as costs of goods sold "the costs otherwise allowed by this section in relation to tangible personal property that the entity rents or leases in the ordinary course of business of the entity."

The amendments to renumbered paragraph (11) memorialize the guidance of the Third Court of Appeals in *Hegar v. Sunstate Equipment Co., LLC*, 2017 WL 279602 at \*5 (Tex. App.—Austin Jan. 20, 2017, pet. filed) (mem. op.). The court agreed with the comptroller's interpretation of Tax Code, § 171.1012(k-1)(2), "which is that Sunstate may deduct 'all direct costs of acquiring or producing the [heavy construction equipment] ' that forms the basis of Sunstate's business, as well as additional costs 'in relation to the taxable entity's [heavy construction equipment].'" The court held, "This reading of the statute is logical and consistent with the apparent purpose of subsection (k-1)—to extend to renters of heavy equipment the same COGS deductions available to a company that sells identical equipment." *Id.*

The amendments provide that certain kinds of motor vehicle rental or leasing companies, a railcar rolling stock rental or leasing company, or a heavy construction equipment rental or leasing company may deduct costs otherwise allowed by Tax Code, §171.1012 in relation to the motor

vehicles, railcar rolling stock, or heavy construction equipment that the entity rents or leases in the ordinary course of its rental or leasing business.

Public Benefit/Cost; Fiscal Implications for state or local government, small businesses, and individuals.

Comments on the proposal may be submitted to Teresa G. Bostick, Director, Tax Policy Division, P.O. Box 13528, Austin, Texas 78711-3528. Comments must be received no later than 30 days from the date of publication of the proposal in the Texas Register.

This amendment is proposed under Tax Code, §111.002 (Comptroller's Rules; Compliance; Forfeiture), which provides the comptroller with the authority to prescribe, adopt, and enforce rules relating to the administration and enforcement of the provisions of Tax Code, Title 2.

This amendment implements Tax Code, §171.1012.

<rule>

§3.588. Margin: Cost of Goods Sold.

(a) Effective Date. The provisions of this section apply to franchise tax reports originally due on or after January 1, 2008, except as otherwise noted.

(b) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

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

(2) Computer program--A series of instructions that are coded for acceptance or use by a computer system and that are designed to permit the computer system to process data and provide results and information. The series of instructions may be contained in or on magnetic tapes, printed instructions, or other tangible or electronic media.

(3) Goods--Real or tangible personal property sold in the ordinary course of business of a taxable entity.

(4) Heavy construction equipment--Self-propelled, self-powered, or pull-type equipment that weighs at least 3,000 pounds and is intended to be used for construction. The term does not include a motor vehicle required to be titled and registered.

(5) Lending institution--An entity that makes loans and:

(A) is regulated by the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, the Office of Thrift Supervision, the Texas Department of Banking, the Office of Consumer Credit Commissioner, the Credit Union Department, or any comparable regulatory body;

(B) is licensed by, registered with, or otherwise regulated by the Department of Savings and Mortgage Lending;

(C) is a "broker" or "dealer" as defined by the Securities Exchange Act of 1934 at 15 U.S.C. §78c;  
or

(D) provides financing to unrelated parties solely for agricultural production.

(6) Principal business activity--The activity in which a taxable entity derives the largest percentage of its "total revenue".

(7) Production--Construction, manufacture, [installation occurring during the manufacturing or construction process,] development, mining, extraction, improvement, creation, raising, or growth.

(8) Related party--A person, corporation, or other entity, including an entity that is treated as a pass-through or disregarded entity for purposes of federal taxation, whether the person, corporation, or entity is subject to the tax under this chapter or not, in which one person, corporation, or entity, or set of related persons, corporations, or entities, directly or indirectly owns or controls a controlling interest in another entity.

(9) 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. For purposes of this section, a service department includes personnel (including costs of recruiting, hiring, relocating, assigning, and maintaining personnel records or employees); accounting (including accounts payable, disbursements, and payroll functions); data processing; security; legal; general financial planning and management; and other similar departments or functions.

(10) Tangible personal property--

(A) includes:

(i) personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner;

(ii) films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound, without regard to the means or methods of distribution or the medium in which the property is embodied, for which, as costs are incurred in producing the property, it is intended or is reasonably likely that any medium in which the property is embodied will be mass-distributed by the creator or any one or more third parties in a form that is not substantially altered; and

(iii) a computer program, as defined in paragraph (2) of this subsection.

(B) does not include:

(i) intangible property or

(ii) services.

(c) General rules for determining cost of goods sold.

(1) Affiliated entities. Notwithstanding any other provision of this section, a payment made by one member of an affiliated group to another member of that affiliated group not included in the combined group may be subtracted as a cost of goods sold only if it is a transaction made at arm's length.

(2) Capitalization or expensing of certain costs. The election to capitalize or expense allowable costs is made by filing the franchise tax report using one method or the other. The election is for the entire period on which the report is based and may not be changed after the due date or the date the report is filed, whichever is later. A taxable entity that is allowed a subtraction by this section for a cost of goods sold and that is subject to Internal Revenue Code, §§263A, 460, or 471 (including a taxable entity subject to §471 that elects to use LIFO under §472), may elect to:

(A) Capitalize those costs in the same manner and to the same extent that the taxable entity capitalized those costs on its federal income tax return, except for those costs excluded under subsection (g) of this section, or in accordance with subsections (d), (e), and (f) of this section. A taxable entity that elects to capitalize costs on its first report due on or after January 1, 2008, may include, in beginning inventory, costs allowable for franchise tax purposes that would be in beginning inventory for federal income tax purposes.

(i) If the taxable entity elects to capitalize those costs allowed under this section as a cost of goods sold, it must capitalize each cost allowed under this section that it capitalized on its federal income tax return.

(ii) If the taxable entity later elects to begin expensing those costs allowed under this section as a cost of goods sold, the entity may not deduct any cost incurred before the first day of the period on which the report is based, including any ending inventory from a previous report.

(B) Expense those costs, except for those costs excluded under subsection (g) of this section, or in accordance with subsections (d), (e), and (f) of this section.



(i) If the taxable entity elects to expense those costs allowed under this section as a cost of goods sold, costs incurred before the first day of the period on which the report is based may not be subtracted as a cost of goods sold.

(ii) If the taxable entity later elects to begin capitalizing those costs allowed under this section as a cost of goods sold, costs incurred prior to the accounting period on which the report is based may not be capitalized.

(3) Election to subtract cost of goods sold. A taxable entity, if eligible, must make an annual election to subtract cost of goods sold in computing margin by the due date, or at the time the report is filed, whichever is later. The election to subtract cost of goods sold is made by filing the franchise tax report using the cost of goods sold method. An amended report may be filed within the time allowed by Tax Code, §111.107 to change the method of computing margin to the cost of goods sold deduction method or from the cost of goods sold deduction method to the compensation deduction method, 70% of total revenue, or, if otherwise qualified, the E-Z computation method. An election may also be changed as part of an audit. See §3.584 of this title (relating to Margin: Reports and Payments).

(4) Exclusions from total revenue. Any expense excluded from total revenue (see §3.587 of this title (relating to Margin: Total Revenue)) may not be included in the determination of cost of goods sold.

(5) Film and broadcasting. A taxable entity whose principal business activity is film or television production or broadcasting or the sale of broadcast rights or the distribution of tangible personal property described by subsection (b)(10)(A)(ii) of this section, or any combination of these activities, and who elects to use cost of goods sold to determine margin, may include as cost of goods sold:

(A) the costs described in this section in relation to the property;

(B) depreciation, amortization, and other expenses directly related to the acquisition, production, or use of the property, including

(C) expenses for the right to broadcast or use the property.

(6) Lending institutions. Notwithstanding any other provision of this section, if the taxable entity is a lending institution that offers loans to the public and elects to subtract cost of goods sold, the entity may subtract as a cost of goods sold an amount equal to interest expense.

(A) This paragraph does not apply to entities primarily engaged in an activity described by category 5932 of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget.

(B) For purposes of this subsection, an entity engaged in lending to unrelated parties solely for agricultural production offers loans to the public.

(7) Mixed transactions. If a transaction contains elements of both a sale of tangible personal property and a service, a taxable entity may only subtract as cost of goods sold the costs otherwise allowed by this section in relation to the tangible personal property sold.

(8) Movie theaters. Effective for reports originally due on or after September 1, 2013, if a taxable entity that is a movie theater elects to subtract cost of goods sold, the cost of goods sold for the taxable entity shall be the costs described by this section in relation to the acquisition, production,

exhibition, or use of a film or motion picture, including expenses for the right to use the film or motion picture.

(9)[(8)] Owner of goods. A taxable entity may make a subtraction under this section in relation to the cost of goods sold only if that entity owns the goods.

(A) The determination of whether a taxable entity is an owner is based on legal title to the goods. If legal title to the goods cannot be determined, all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxable entity, will be considered.

(B)[(A)] A taxable entity furnishing labor or materials to a project[ for the construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in §3.357 of this title (relating to Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance)), of real property] is considered to be an owner of the labor or materials and may include the costs, as allowed by this section, in the computation of the cost of goods sold. For purposes of this paragraph, the following terms mean:

(i) Labor--Labor used in the direct prosecution of the project.

(ii) Material--All or part of:

(I) the material, machinery, fixtures, or tools incorporated into the project, consumed in the direct prosecution of the project, or ordered and delivered for incorporation or consumption;

(II) rent at a reasonable rate and actual running repairs at a reasonable cost for construction equipment used or reasonably required and delivered for use in the direct prosecution of the project at the site of the project; or

(III) power, water, fuel, and lubricants consumed or ordered and delivered for consumption in the direct prosecution of the project.

(iii) Project--The construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in §3.357 of this title (relating to Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance)) of real property.

(C)[(B)] Solely for the purposes of this section, a taxable entity shall be treated as the owner of goods being manufactured or produced by the entity under a contract with the federal government, including any subcontracts that support a contract with the federal government, notwithstanding that the Federal Acquisition Regulations may require that title or risk of loss with respect to those goods be transferred to the federal government before the manufacture or production of those goods is complete.

(10) Pipeline entities. Effective for reports originally due on or after January 1, 2014, and notwithstanding paragraph (9) of this subsection and subsection (g)(3) of this section, a pipeline entity that provides services for others related to the product that the pipeline does not own and to which this paragraph applies may subtract as a cost of goods sold its depreciation, operations, and maintenance costs allowed by this section related to the services provided.

(A) For purposes of this paragraph, "pipeline entity" means an entity:

(i) that owns or leases and operates the pipeline by which the product is transported for others and only to that portion of the product to which the entity does not own title; and

(ii) that is primarily engaged in gathering, storing, transporting, or processing crude oil, including finished petroleum products, natural gas, condensate, and natural gas liquids, except for a refinery installation that manufactures finished petroleum products from crude oil.

(B) For purposes of this paragraph, "processing" means the physical or mechanical removal, separation, or treatment of crude oil, including finished petroleum products, natural gas, condensate, and natural gas liquids after those materials are produced from the earth. The term does not include the chemical or biological transformation of those materials.

(11)[(9)] Rental or leasing companies[Rentals and leases]. Notwithstanding any other provision of this section[, the following taxable entities may subtract as cost of goods sold the costs otherwise allowed by this section in relation to tangible personal property that the entity rents or leases in the ordinary course of business of the entity]:

(A) a motor vehicle rental company that remits a tax on gross receipts imposed under Tax Code, §152.026, or a motor vehicle leasing company, may subtract as costs of goods sold the costs otherwise allowed by this section in relation to motor vehicles that the company rents or leases in the ordinary course of its business;

(B) a heavy construction equipment rental or leasing company may subtract as costs of goods sold the costs otherwise allowed by this section in relation to heavy construction equipment that the company rents or leases in the ordinary course of its business; and

(C) a railcar rolling stock rental or leasing company may subtract as costs of goods sold the costs otherwise allowed by this section in relation to railcar rolling stock that the company rents or leases in the ordinary course of its business.

(12)[(10)] Reporting methods. A taxable entity shall determine its cost of goods sold, except as otherwise provided by this section, in accordance with the methods used on the federal income tax return on which the report under this chapter is based. This subsection does not affect the type or category of cost of goods sold that may be subtracted under this section.

(13)[(11)] Restaurants and bars. Entities engaged in activities described in Major Group 58 (Eating and Drinking Places) of the Standard Industrial Classification Manual may deduct for cost of goods sold only those expenses allowed under subsections (d), (e) and (f) of this section, that relate to the acquisition and production of food and beverages. Any costs related to both the production of food and beverages and to other activities must be allocated to production on a reasonable basis.

(d) Direct costs. The cost of goods sold includes all direct costs of acquiring or producing the goods. Direct costs include:

(1) Labor costs. A taxable entity may include in its cost of goods sold calculation labor costs, other than service costs, that are properly allocable to the acquisition or production of goods and are of the type subject to capitalization or allocation under Treasury Regulation Sections 1.263A-1(e) or 1.460-5 as direct labor costs, indirect labor costs, employee benefit expenses, or pension and other related costs, without regard to whether the taxable entity is required to or actually capitalizes such costs for federal income tax purposes.

(A) For purposes of this section, labor costs include W-2 wages, IRS Form 1099 payments for labor, temporary labor expenses, payroll taxes, pension contributions, and employee benefits expenses, including, but not limited to, health insurance and per diem reimbursements for travel expenses, to the extent deductible for federal tax purposes.

(B) Labor costs under this paragraph shall not include any type of costs includable in subsection (f) or excluded in subsection (g) of this section. Costs for labor that do not meet the requirements set forth in this paragraph may still be subtracted as a cost of goods sold if the cost is allowed under another provision of this section. For example, service costs may be included in a taxable entity's cost of goods sold calculation to the extent provided by subsection (f) of this section.

(2) Incorporated materials. A taxable entity may include in its cost of goods sold calculation the cost of materials that are an integral part of specific property produced.

(3) Consumable materials. A taxable entity may include in its cost of goods sold calculation the cost of materials that are consumed in the ordinary course of performing production activities.

(4) Handling costs. A taxable entity may include in its cost of goods sold calculation handling costs, including costs attributable to processing, assembling, repackaging, and inbound transportation.

(5) Storage costs. A taxable entity may include in its cost of goods sold calculation storage costs, including the costs of carrying, storing, or warehousing property, subject to subsection (g) of this section, concerning excluded costs.

(6) Depreciation, depletion, and amortization. A taxable entity may include in its cost of goods sold calculation depreciation, depletion, and amortization reported on the federal income tax return on which the report under this chapter is based, to the extent associated with and necessary for the production of goods, including recovery described by Internal Revenue Code, §197, and property described in Internal Revenue Code, §179.

(7) Rentals and leases. A taxable entity may include in its cost of goods sold calculation the cost of renting or leasing equipment, facilities, or real property directly used for the production of the goods, including pollution control equipment and intangible drilling and dry hole costs.

(8) Repair and maintenance. A taxable entity may include in its cost of goods sold calculation the cost of repairing and maintaining equipment, facilities, or real property directly used for the production of the goods, including pollution control devices.

(9) Research and development. A taxable entity may include in its cost of goods sold calculation the costs attributable to research, experimental, engineering, and design activities directly related to the production of the goods, including all research or experimental expenditures described by Internal Revenue Code, §174.

(10) Mineral production. A taxable entity may include in its cost of goods sold calculation geological and geophysical costs incurred to identify and locate property that has the potential to produce minerals.

(11) Taxes. A taxable entity may include in its cost of goods sold calculation taxes paid in relation to acquiring or producing any material, including property taxes paid on buildings and equipment, and taxes paid in relation to services that are a direct cost of production.

(12) Electricity. A taxable entity may include in its cost of goods sold calculation the cost of producing or acquiring electricity sold.

(13) A taxable entity may include in its cost of goods sold calculation a contribution to a partnership in which the taxable entity owns an interest that is used to fund activities, the costs of which would otherwise be treated as cost of goods sold of the partnership, but only to the extent



that those costs are related to goods distributed to the contributing taxable entity as goods-in-kind in the ordinary course of production activities rather than being sold by the partnership.

(e) Additional costs. In addition to the amounts includable under subsection (d) of this section, the cost of goods sold includes the following costs in relation to the taxable entity's goods:

(1) deterioration of the goods;

(2) obsolescence of the goods;

(3) spoilage and abandonment, including the costs of rework, reclamation, and scrap;

(4) if the property is held for future production, preproduction direct costs allocable to the property, including storage and handling costs, as provided by subsection (d)(4) and (5) of this section;

(5) postproduction direct costs allocable to the property, including storage and handling costs, as provided by subsection (d)(4) and (5) of this section;

(6) the cost of insurance on a plant or a facility, machinery, equipment, or materials directly used in the production of the goods;

(7) the cost of insurance on the produced goods;

(8) the cost of utilities, including electricity, gas, and water, directly used in the production of the goods;

(9) the costs of quality control, including replacement of defective components pursuant to standard warranty policies, inspection directly allocable to the production of the goods, and repairs and maintenance of goods; and

(10) licensing or franchise costs, including fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right directly associated with the goods produced.

(f) Indirect or administrative overhead costs. A taxable entity may subtract as a cost of goods sold service costs, as defined in subsection (b)(9) of this section, that it can demonstrate are reasonably allocable to the acquisition or production of goods. The amount subtracted may not exceed 4.0% of total indirect and administrative overhead costs.

(1) Any costs already subtracted under subsections (d) or (e) of this section may not be subtracted under this subsection.

(2) Any costs excluded under subsection (g) of this section may not be subtracted under this subsection.

(g) Costs not included. The cost of goods sold does not include the following costs in relation to the taxable entity's goods:

(1) the cost of renting or leasing equipment, facilities, or real property that is not used for the production of the goods;

(2) selling costs, including employee expenses related to sales;

(3) distribution costs, including outbound transportation costs;

(4) advertising costs;

(5) idle facility expenses;

(6) rehandling costs;

(7) bidding costs, which are the costs incurred in the solicitation of contracts ultimately awarded to the taxable entity;

(8) unsuccessful bidding costs, which are the costs incurred in the solicitation of contracts not awarded to the taxable entity;

(9) interest, including interest on debt incurred or continued during the production period to finance the production of the goods;

(10) income taxes, including local, state, federal, and foreign income taxes, and franchise taxes that are assessed on the taxable entity based on income;

(11) strike expenses, including costs associated with hiring employees to replace striking personnel, but not including the wages of the replacement personnel, costs of security, and legal fees associated with settling strikes;

(12) officers' compensation;

(13) costs of operation of a facility that is:

(A) located on property owned or leased by the federal government; and

(B) managed or operated primarily to house members of the armed forces of the United States;

(14) any compensation paid to an undocumented worker used for the production of goods, provided that, as used in this paragraph only, the following terms shall have the following meanings:

(A) "undocumented worker" means a person who is not lawfully entitled to be present and employed in the United States; and

(B) "goods" includes the husbandry of animals, the growing and harvesting of crops, and the severance of timber from realty; and

(15) costs funded by a partnership contribution, to the extent that the contributing taxable entity made the cost of goods sold deduction under subsection (d)(13) of this section.

This agency hereby certifies that the proposal has been reviewed by legal counsel and found to be within the agency's authority to adopt.

Issued in Austin, Texas, on

LITA GONZALEZ  
General Counsel  
Comptroller of Public Accounts  
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