State Tax Quarterly Insights

Highlighting legislative developments and the Multistate Tax Compact

This quarter we highlight two enacted pieces of state legislation and our continuing commentary on the Multistate Tax Compact.

Minnesota implemented significant tax changes, including the repeal of foreign operating corporation provisions, repeal of foreign royalty deductions, inclusion of foreign disregarded entities in unitary groups, and repeal of the Multistate Tax Compact.

Texas experienced both legislative and regulatory changes. H.B. 500 enacted a temporary margin tax rate reduction and expanded certain deductions. A change to 34 TAC §3.588 provides guidance regarding the cost of goods sold rule. Additionally, the rule allows taxpayers to change their margin tax computation method on an amended report and while under audit.

PwC continues its leadership in the Multistate Tax Compact debate this quarter by issuing two articles. The first begins here on page 5 and explores the impact of Compact withdrawals on the joint audit program. The second, published in State Notes, examines the *Gillette* decision and the significance of interstate agreements.

Every item in the *developments* section, starting on page 12, links to a PwC Insight that provides analysis and observations regarding the development. Insights this quarter examine the Multistate Tax Compact apportionment election, nexus developments, budget and legislative proposals, and other significant state and local tax matters. One trend to observe is the expansion of nexus both legislatively and though case law. In this quarter, we report on four states that enacted expanded nexus laws– though affiliate or agency nexus provisions - and two state court decisions that upheld the application of expanded nexus concepts.

Key state developments

Minnesota enacts significant tax changes, including Compact repeal

In brief

On May 23, 2013, Governor Mark Dayton signed H.F. 677, which makes significant changes to Minnesota corporate income tax, individual income tax, and sales and use tax, including repeal of the Multistate Tax Compact. Corporate income tax changes include repeal of foreign operating corporation provisions, repeal of foreign royalty deductions, inclusion of foreign disregarded entities in unitary groups, and adoption of a *Finnigan* apportionment approach. The personal income tax rate increases. Sales and use tax changes include tax base expansion to certain business purchases and services, click-through nexus, multiple points of use exemption certificates, and a capital equipment exemption. Finally, the bill requires remote sellers to collect and pay sales and use tax consistent with federal legislation.

In detail

Multistate Tax Compact repeal

H.F. 677 repeals Minn. Stat. sec. 290.171, which enacts the Multistate Tax Compact. However, the bill authorizes the commissioner to participate in audits performed by the Multistate Tax Commission. Because the bill provides no specific effective date, the Compact repeal takes effect on August 1, 2013. It remains unclear to which taxable year the repeal applies.

Corporate income tax

All corporate income tax provisions below are effective for tax years beginning after 2012.

Repeal of foreign operating corporation provisions

Under current law, a foreign operating corporation (FOC) generally includes a domestic corporation, in a unitary relationship with a Minnesota taxpayer, with at least 80% of its gross income derived from active foreign business income. FOCs are not required to file a Minnesota return and may not file as members of a unitary group. Special rules applicable to FOCs include: (1) deemed dividends of a FOC are added to a taxpayer's federal taxable income, subject to certain reductions; and (2) royalties, fees, or other like income received from a FOC are generally subject to an 80% deduction.

H.F. 677 provides that FOCs are no longer excluded from filing a Minnesota return or from filing as members of a unitary group. Provisions regarding FOCs are repealed, including the deemed dividend provision and the 80% royalty deduction.

Repeal of foreign royalty deduction

In addition to eliminating the royalty deduction for FOCs, the legislation repeals the royalty deduction from any other foreign corporation (currently at 80%).

Inclusion of foreign check-the-box entities in a unitary group

Under current law, Minnesota carves out the income and apportionment factors of foreign corporations and other foreign entities from a unitary group. H.F. 677 provides that the income and apportionment factors of a disregarded foreign entity flows to its *unitary* domestic owner for purposes of calculating net income and apportionment factors of a unitary business to the extent the income is included in federal taxable income. Specifically, the language states:

> "income and apportionment factors of a foreign entity, other than an entity treated as a C corporation for federal income tax purposes, that are included in the federal taxable income . . . of a domestic corporation, domestic entity, or individual must be included in determining net income and the factors to be used in the apportionment of net income."

A *non-unitary* foreign entity would file on a separate basis, if it is required to file a Minnesota return.

Finnigan sales factor sourcing

Under current law, Minnesota is a *Joyce* sales factor sourcing state. H.F. 677 provides that "all sales of the unitary business made within [Minnesota] . . . must be included on the combined report" of a member with nexus with Minnesota.

Dividends from a REIT

Under current law, Minnesota generally provides for a dividends received deduction of either 70% or 80% depending on the ownership percentage in the subsidiary. H.F. 677 provides that dividends from a real estate investment trust do not qualify for the deduction.

Research and development credit no longer refundable

Current law provides that taxpayers whose qualified research and development credits exceed their tax liability, for tax years beginning after 2009, receive a refund for such excess.

Under H.F. 677, excess research and development credits are not refundable for tax years beginning after 2012. The excess credit would be carried forward for fifteen years.

Individual income tax

Effective for tax years beginning after 2012, H.F. 677 expands Minnesota's existing three personal income tax brackets, and creates a new 4th tier income tax bracket at a rate of 9.85% for joint married filers with income over $250,000 and for unmarried individuals with income over $150,000.

Sales tax

Digital products taxable

Effective July 1, 2013, the sale and purchase of 'specified digital products' and 'other digital products' are subject to sales and use tax. The legislation defines 'specified digital products' as "digital audio works, digital audiovisual works, and digital books that are transferred electronically to a customer" and defines 'other digital products' to mean electronically delivered greeting cards and online video or electronic games.

Certain repair and maintenance taxable

Effective July 1, 2013, repair and maintenance of electronic precision equipment deductible as a business expense federally are subject to sales and use tax. Such equipment includes electronic devices, computers, computer peripherals, monitors, office equipment, medical equipment, and communications equipment.

Effective July 1, 2013, repair and maintenance of commercial and industrial machinery and equipment are subject to sales and use tax. Such machinery and equipment do *not* include motor vehicles, furniture and fixtures, ships, railroad stock, and aircraft.

Warehousing and storage services taxable

Effective April 1, 2014, warehousing or storage services for tangible personal property are subject to sales and use tax, excluding: (1) agricultural products; (2) refrigerated storage; (3) electronic data; and (4) self-storage services and storage of motor vehicles, recreational vehicles, and boats, not eligible to be deducted as a business expense under the Internal Revenue Code.

The effective date was delayed because lawmakers appeared to have difficulty determining exactly which services would become taxable. The delay provides until next April to potentially revise the language.

Click-through nexus

Current law provides that a retailer is doing business in Minnesota if it has a solicitor operating in the state. Effective July 1, 2013, H.F. 677 provides a definition of 'solicitor,' which means a person, whether an independent contractor or other representative, who directly solicits business for the retailer.

H.F. 677 provides that a retailer is presumed to have a solicitor in Minnesota if the retailer "enters into an agreement with a resident under which the resident, for a commission or other substantially similar consideration, directly or indirectly refers potential customers, whether by a link on an Internet Web site, or otherwise, to the

seller." The total gross receipts from sales to referred Minnesota customers must be at least $10,000 in a 12-month period.

The above presumption may be rebutted by proof that the resident with whom the retailer has an agreement did not engage in any solicitation in the state on behalf of the retailer that would satisfy the nexus requirements of the US Constitution during the 12-month period in question.

Multiple points of use exemption certificate authorized

Effective July 1, 2013, H.F. 677 authorizes a purchaser that does not have a direct pay permit to use an exemption certificate indicating multiple points of use if: (1) the purchaser knows at the time of its purchase of a digital good, computer software delivered electronically, or a service that the good or service will be concurrently available for use in more than one taxing jurisdiction; and (2) the purchaser delivers to the seller the exemption certificate indicating multiple points of use at the time of purchase.

Capital equipment exemption

Under current law, capital equipment is exempt from sales tax. However, the tax must be imposed and collected, and then taxpayers must apply for a refund.

Effective September 1, 2014, the legislation repeals all capital equipment refund provisions and create an upfront exemption for the sale or lease of capital equipment (including machinery and equipment used for manufacturing, fabricating, mining, or refining).

Remote sellers

H.F. 677 requires retailers without a Minnesota place of business to collect and remit sales and use tax "in accordance with the terms and conditions of federal remote seller law." This allows the state to subject remote sellers to its sales and use tax consistent with federal legislation (like the Marketplace Fairness Act), if enacted.

The takeaway

H.F. 677 is the outcome of the legislative debate on a series of bills and gubernatorial announcements this year proposing significant tax change in Minnesota. Proposals that failed to make their way into H.F. 677 include an expanded sales tax base to include most services, a reduced corporate franchise tax rate, a reduced sales tax rate, and economic substance disallowance and related penalties.

The legislation effectively reverses the Minnesota Supreme Court decision in *Manpower, Inc. v Commissioner of Revenue* (Minn. Supreme Court, No. A-06-468, December 7, 2006), which held that foreign check-the-box entities are excludable from Minnesota taxable income.

Let's talk

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The impact of multistate tax compact withdrawals on the joint audit program

Introduction

The infamous Greenbrier Hotel is an award winning luxury resort with a long-storied history. Located in the Allegheny Mountains of West Virginia, the resort was a center of post-Civil War society. During World War II, the resort served both as an army hospital and as an internment facility for Japanese, Italian and German diplomats. In the late 1950s, a uniquely ambitious and secretive project took place at the Greenbrier. The US government approached the hotel owners and asked for assistance in creating a secret emergency relocation center to house Congress in the aftermath of a nuclear attack. The classified, underground facility was discretely built at the same time as an above-ground addition to the hotel. Rumor has it that even the spouses of the construction workers didn't know of the stealth project. For over thirty years, with thousands of guests staying at the Greenbrier, no one who visited the hotel even knew of the underground facility's existence, yet it was large enough to house all members of Congress for an extended period of time. The secret location stayed hidden until the early 1990s when a Washington Post reporter revealed the existence of "Congress' bunker" after extensive research into the late 1950s hotel expansion.[1] The concept behind the now declassified facility was simple: people don't notice the most obvious of things.

At the same time the bunker was being built in West Virginia, the Uniform Division for Income Tax Purposes Act (UDITPA) was being drafted by the National Conference of Commissioners on Uniform State Laws. [2]A few years later, when the Multistate Tax Compact (Compact) became effective, it adopted UDITPA as Article IV. Recently, a number of states have withdrawn from the Multistate Tax Compact. South Dakota withdrew in March. [3] In April, Utah withdrew from the Compact but temporarily re-enacted the Compact with the exception of Article III, the apportionment election provision, and Article IV, the UDITPA provision. [4]In May, Minnesota withdrew from the Compact, but simultaneously enacted a provision giving the commissioner the power to authorize participation in audits performed by the Multistate Tax Commission. [5]At the time of this writing, the Oregon legislature has passed a bill that would withdraw the state from the Compact and the bill is now before the Governor.[6]

With these recent state withdrawals from the Multistate Tax Compact, a number of issues arise, including the impact they will have on the joint audit program authorized under Article VIII of the Compact. Will the states that have repealed the Compact but re-enacted all provisions except for Articles III and IV still be considered "members" of the Compact and be able to continue to participate in the joint audit program? What about the states that repeal the Compact but legislatively provide the tax commissioner with the authority to participate in the joint audit program? Does it even matter whether states are "members" of the Compact? A careful review of the plain language found in Articles VI and VIII (described below) may reveal something not noticed about the limitations the Compact places on the joint audit program. To recognize these limitations, however, one must understand the permissible functions, powers and duties of the Multistate Tax Commission as established under interstate compact law.

Interstate Compact Agreements – Compact Governance

Interstate compacts are formal agreements among states that have both statutory and contractual aspects. Since compacts are statutes enacted by state legislatures, the entire body of legal principles applicable to statutory interpretation apply. In

[1] http://www.washingtonpost.com/wp-srv/local/daily/july/25/brier1.htm
[2] UDITPA was approved at the 66th Annual Conference of the National Conference of Commissioners on Uniform State Laws in July, 1957.
[3] South Dakota SB 239.
[4] Utah SB 247.
[5] Minnesota HF 677.
[6] Oregon SB 307.

addition, compacts are contractual because of the manner in which they are adopted. A violation of compact terms, like a breach of contract, is subject to judicial review.[7]

State legislators may enter into interstate compacts and delegate to an administrative body the power to make rules, establish committees, study systems, compile and publish information, audit and perform other clearly delineated functions. In 1951, the US Supreme Court in Dyer v. Sims upheld states' power to create interstate commissions through the adoption of an interstate compact.[8] Notably, the Court recognized the need for "a carefully limited delegation of power to an interstate agency." [9]That is because, in part, the more authority an administrative body has, the greater the potential danger that may result from the diminished ability of the party states to govern the very agency they created. This concern is particularly true because of the difficulty in amending compact terms by all party states. Thus, it is essential that the powers vested in an administrative body be clearly defined and carefully followed. This may be why, for example, compact terms often provide for the issuance of reports to the state legislatures and governors covering activities for the preceding year. Modern compacts place a great deal of attention on the governing provisions.[10]

The Multistate Tax Compact

In *United States Steel Corp. v. Multistate Tax Commission* the US Supreme Court held the Multistate Tax Compact is a valid and binding interstate compact between signatory states.[11] The Compact became effective, according to its own terms, in 1967 after seven states had adopted it. Article VI of the Compact creates the Multistate Tax Commission (the Commission), composed of tax administrators from all the member states. There are a number of sections within the Compact that clearly define the functions and powers granted to the Commission.

Article VI, Section 3 authorizes the Commission to:

(a) study state and local tax systems and particular types of state and local taxes; (b) develop and recommend proposals for an increase in uniformity or compatibility of state and local tax laws with a view toward encouraging the simplification and improvement of state and local tax law and administration; (c) compile and publish information as in its judgment would assist the party states in implementation of the Compact and taxpayers in complying with state and local tax laws; and (d) do all things necessary and incidental to the administration of its functions pursuant to this Compact

Article VII addresses the Commission's powers related to uniform administrative regulations and forms.

Article VIII applies only in those states that specifically adopt it by statute. The Article authorizes "any party state" to request that the Commission perform an audit on its behalf:

Any party state or subdivision thereof desiring to make or participate in an audit of any accounts, books, paper, records or other documents may request the commission to perform the audit on its behalf. . . The commission may enter into agreements with party states or their subdivisions for assistance in performance of the audit. . . Information obtained by any audit pursuant to this article shall be confidential and available only for tax purposes to party states, their subdivisions or the United States. Availability of information shall be in accordance with the laws of the States or subdivisions on whose account the commission performs the audit, and only through the appropriate agencies or officers of such States or subdivisions. Nothing in the Article shall be construed to require any taxpayer to keep records for any period not otherwise required by law.

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[7] See the National Center for Interstate Compacts' website at http://www.csg.org/ncic/ for more information on interstate compacts.
[8] *Dyer v. Sims*, 341 US 22 (1951).
[9] *Id.* at 30.
[10] http://www.csg.org/knowledgecenter/docs/ncic/Success.pdf
[11] *United States Steel Corp. v. Multistate Tax Commission*, 434 US 452 (1978).

As the US Supreme Court in *Dyer* suggested, the Compact language should be considered a carefully limited delegation of authority. Thus Articles VI, VII and VIII appear to establish the universe of functions and powers delegated to the Commission. Under principles of interstate compact law, the Multistate Tax Compact does not provide its administrative agency, the Commission, with any additional authority.

Current Commission Practice for Interstate Audits

The Commission engages in interstate audits of member states, sovereignty members, and associate and project members, including states that have merely statutorily granted authority to enter into a contract to participate in the audit program.[12] The Commission's audit committee, which is comprised of representatives from each state (including non-party states) that participates in the joint audit program, is responsible for choosing audit targets.[13] The Commission's audit staff performs audits "as though they were part of a state's own audit staff, forwarding their findings and recommendations to the member states for assessment and collection at the completion of the audit."[14] The Commission website describes how the Audit Program works and its benefits and goals. The website has links to documents describing the Audit Selection Process, the Sales Tax Joint Audit Process, and the Income Tax Joint Audit Process. The website also indicates that "the information presented in the Audit Program web pages is also available for downloading or printing" in a document called the "Report on the MTC Joint Audit Program." There is a page dedicated to explaining how taxpayers can request a joint audit. The site also has pages on The Audit Committee as well as Training Programs and Resource Documents, including the audit manuals for income tax and sales tax. There is extensive documentation on Statistical Sampling as well.[15]

States decide whether or not to participate in a given audit and how to address the audit findings. The information obtained during these audits, as provided under Article VIII, is confidential but made available to member and participating states. In addition, states may share with the Commission information obtained from their separate audits.[16]

Two of the issues taxpayers seem to be most concerned with are the 51 state spreadsheet requested in Commission audits and that the states do not have to accept the Commission audit findings often resulting in further audit procedures by the individual states.

In What States May the Commission Audit and Share Information?

Party States

As noted above, the Compact gives the Commission authority to audit and share information with any "party state or subdivision thereof." Nothing within the Compact provides the Commission with authority to audit or share information other than with party states. What is a "party state?" While the term is used forty nine times throughout the Compact, no definition is provided.[17]

Since the Compact is a statute, the definition of "party state" may be determined using statutory analysis of its plain meaning and legislative intent. The legal analysis of the meaning of "party state" will be left to taxpayers and their attorneys. However, guidance may be found by simply looking to Compact language. Article VI of the

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[12] *See e.g.*, Wisconsin Sec. 73.03 (28d). It shall be the duty of the department of revenue, and it shall have the power and authority: To enter into a contract to participate in the multistate tax commission audit program. *See also*, Minnesota HF 677. Sec. 270C.03, sub. 1. The commissioner shall have and exercise the following powers and duties: (9) authorize the participation in audits performed by the Multistate Tax Commission. For the purposes of chapter 270B, the Multistate Tax Commission will be considered to be a state for the purposes of auditing corporate sales, excise and income tax returns.

[13] See appendix for a list of states that participate in the joint audit program.

[14] See www.mtc.gov for information on the MTC audit program.

[15] See http://www.mtc.gov/Audit.aspx?id=578

[16] See, *e.g., Oregon Sec. 314.840(2): The Department may disclose and give access to information described in ORS 314.835 to . . . (d) The Multistate Tax Commission or its authorized representatives, for tax administration and compliance purposes only.*

[17] In its Public Participation Policy document, the Commission defines "member state" as "a party State of the Multistate Tax Compact, an associate or sovereignty member State of the Commission or any State participating in a Commission program."

Compact provides: "The Multistate Tax Commission is hereby established. It shall be composed of one 'member' from each party state."[18] There does not appear to be anything unclear about the drafters' intent. A literal reading of Article VI may lead reasonable persons to agree that party states are only those states that may have members on the Multistate Tax Commission. Bylaw 13 of the Commission states: "The Commission provides opportunities for sovereignty, associate, and project membership to those states that have not effectively enacted the Compact. . . Sovereignty members are states that support the purposes of the Multistate Tax Compact and work with the Commission and its member states . . . Representatives of sovereignty members . . . are not eligible to serve as an elected member of the Executive Committee." The Compact and the bylaws clearly treat party member states differently than sovereignty and other member states. That is, party states are afforded more rights than other types of member states. At a minimum, this calls into question whether any state other than one that has effectively enacted the Compact may be considered a party state that can participate in a joint audit under Article VIII. The confidentiality provisions of Article VIII are also clear: information sharing is limited to party states and only for tax purposes. Since information is currently shared with non-party states, one wonders about the consequences of joint audits that result in the sharing of taxpayer confidential information with these non-party states.[19]

Partial Re-Enactment States

What does it mean to "effectively enact the Compact?" Have states that have withdrawn from the Compact and re-enacted all its provisions except for Articles III and IV effectively enacted the Compact? May these states be considered party states? The Commission has informally indicated it will entertain treating these states as full members (party states) if the re-enactment of the Compact is in "substantially similar form" to other states, as stated in the Compact's suggested enabling language.[20] What does it mean to be in "substantial similar form?" Can a state that enacts all Compact provisions except Articles III and IV be substantially similar to states that have adopted all provisions of the Compact?

Articles III and IV were critical to the adoption of the Compact and would therefore appear to be material and substantial provisions of the Compact.[21] A brochure issued by the Commission in 1968 makes that clear, as the choice of using Article IV was the "promise" made. Indeed, it is because of these two provisions that states are legislatively withdrawing from the Compact. How can one argue that these provisions are insubstantial? A plain understanding of what led to the Compact in the first place may lead one to conclude that adoption of a compact without Articles III and IV would not be substantially similar to complete adoption of the Compact.

States that Legislatively Provide Authority to Participate in the Joint Audit Program

What about the states that have merely provided for participation in the joint audit program by statute? Despite the states' statutory authorization, how the Commission's authority extends to the auditing of these states is unclear when one considers the grant of authority to the Commission as delineated in Articles VI, Section 3, Article VII and Article VIII. When read together, the Commission appears to have only one grant of audit authority, and that is to audit on behalf of "party" states. They are not granted any other powers by the Compact to audit for non-party states.

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[18] The Commission's Public Participation Policy, Section 2, distinguishes between party states and sovereignty, associate and participating states.
[19] The Litigation Saga of Gilbert P. Hyatt v. State of California: An Update. State Tax Notes, May 27, 2013, p. 689, 68 State Tax Notes 689 (May 27, 2013).
[20] Utah Governor Signs Bill to Withdraw From Multistate Tax Compact. State Tax Notes, Amy Hamilton, April 4, 2013 Doc 2013-7956. Suggested Enabling Act, Section 1: The "Multistate Tax Compact" is hereby enacted into law and entered into with all jurisdictions legally joining therein, in the form substantially as follows . . .
[21] See The Multistate Tax Compact -- A Promise Forgotten by Michael Herbert and Bryan Mayster for a discussion of Articles III and IV. 2012 STT 223-4.

Conclusion

An interstate compact may delegate to an administrative body powers to address the common goals of its members. A compact itself establishes the parameters of that administrative body's powers. The Multistate Tax Compact clearly defines the powers granted to the Multistate Tax Commission, including the right to conduct joint audits of party states. While party state is not defined, its usage within the Compact and bylaws appears to reference only full member states that have enacted the Compact. As states withdraw from the Compact, one must ask whether the Commission has the authority to audit on behalf of these non-party states. Although the Commission may only make audit recommendations to the individual states, it also may share confidential information obtained during the audit. If information sharing is limited to party states, at issue are the consequences of the Commission sharing this information outside the boundaries of its stated powers.

Let's talk

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Appendix

The following states participate in the respective audit programs as of June 1, 2013. The highlighted states are non-party states.

State	Income Tax	Sales Tax
Alabama	X	X
Alaska	X	
Arkansas	X	X
Colorado	X	X
District of Columbia	X	X
Georgia		X
Hawaii	X	X
Idaho	X	X
Illinois	X	X
Kansas	X	X
Kentucky	X	X
Louisiana		X
Massachusetts	X	X
Michigan	X	X
Minnesota	X	X
Missouri	X	
Montana	X	
Nebraska	X	
New Jersey	X	X
New Mexico	X	
North Dakota	X	X
Oregon [22]	X	
South Carolina	X	X
Tennessee	X	X
Utah [22]	X	X
Washington		
West Virginia	X	
Wisconsin	X	X

[22] Oregon and Utah have withdrawn from the Compact and temporarily re-enacted all provisions except Articles III, IV and IX.

Texas enacts margin tax amendments, Comptroller finalizes changes to cost of goods sold rule

In brief

House Bill 500, enacts a temporary margin tax rate reduction, allows additional businesses to qualify for a reduced rate, provides a new minimum deduction of $1 million, expands deductions (including the cost of goods sold deduction), provides customer based sourcing for Internet hosting receipts, repeals information reporting requirements for combined group non-nexus members, and makes other changes. Except as noted, the legislation takes effect January 1, 2014.

In addition, the Comptroller of Public Accounts (Comptroller) adopted amendments to 34 TAC §3.588, the cost of goods sold (COGS) rule, allowing taxpayers to include as COGS both direct labor costs and those indirect labor costs, other than service costs, that are subject to capitalization under Treasury Rules interpreting IRC §263A or §460 without regard to whether the taxpayer is required to or actually capitalizes the costs for federal income tax purposes. Additionally, the rule allows taxpayers to change their margin tax computation method on an amended report and while under audit. The amendments took effect on June 5, 2013.

With the enactment of the legislation and the adopted amendments to the COGS rule, taxpayers should review their current Texas margin tax calculation, previously filed returns, and previous audit adjustments for potential tax savings or refund claims.

In detail

Margin tax legislation - House bill 500

Tax rates

The margin tax is imposed at the rate of 0.5% on retail and wholesale trade businesses and 1% on all other taxpayers. Under H.B. 500, margin tax rates are temporarily reduced as follows:

- for reports due in 2014, the rate will be 0.4875% for retailers or wholesalers and 0.975%
- for other taxpayers for reports due in 2015, the rate will be 0.475% for retailers or wholesalers and 0.95% for other taxpayers.

The legislation requires that taxpayers elect to compute the margin tax at the lower rate. For reports due in 2015, the election will only be available if probable revenue estimates, as certified by the Comptroller, exceed previous estimates so that any revenue loss caused by the rate reduction would be offset. The rates return to their current levels after 2015.

Under H.B. 500, the following businesses qualify as retailers and are subject to the reduced tax rate: automotive repair shops, qualified heavy construction equipment rental or leasing businesses, rent-to-own businesses, and rental or leasing businesses under SIC Industry classification 7359.

The legislation provides tax relief for small businesses by including a $1 million deduction from total revenue.

Cost of goods sold, other deductions and exclusions

House Bill 500 allows:

- a pipeline company that transports oil, gas, or other petroleum products owned by others to subtract as COGS its depreciation, operations, and maintenance costs related to the services provided
- a movie theater to subtract as COGS its costs related 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 (the legislation specifies that this is simply a clarification of the existing law)

- a taxable entity to deduct from its apportioned margin relocation costs incurred in relocating its main office or other principal place of business if the taxable entity (including any affiliates in the combined group) was not previously doing business in Texas.

Additional revenue exclusions are adopted for: pharmacy networks, certain reimbursements to pharmacies, landman service providers, certain subcontracting payments, transporters of extracted construction materials (e.g., concrete) and barite, certain subcontracting payments, transporters via waterways (that do not claim the cost of goods sold deduction) for direct costs of providing transportation services, cost of vaccines, and taxes and fees received by certain registered motor carriers.

Other provisions

In addition, H.B.500 provides the following:

- Receipts from Internet hosting are sourced to Texas for receipts factor purposes only if the customer to whom the service is provided is in Texas.
- The requirement that combined groups disclose the gross receipts of each combined group member that does not have nexus with Texas is repealed.
- Retail or wholesale electric utilities are prohibited from being included in a combined group with other taxable entities that do not provide such services if certain requirements are met.
- The exemption from tax for nonadmitted insurance companies is clarified.
- A tax credit for qualified rehabilitation costs of certified historic structures is created.

Cost of goods sold rule – 3.588

Labor costs

Under the adopted rule amendment, a taxable entity may include as COGS labor costs, other than service costs, that are properly allocable to the acquisition or production of goods and are of the type of costs subject to capitalization or allocation under Treasury Regulation §§1.263A-1(e) or 1.460-5 as direct labor costs, indirect labor costs, employee benefit expenses, or pension and other related costs, regardless of whether the taxable entity actually capitalizes these costs for federal income tax purposes. Labor costs include W-2 wages, IRS Form 1099 payments for temporary labor expenses, payroll taxes, pension contributions, and employee benefit expenses including per diem reimbursements for travel expenses, to the extent deductible for federal tax purposes. Labor costs that do not meet the requirements outlined above may still be deductible if the cost is allowed under another provision of the rule such as handling costs.

Indirect or administrative overhead costs as 'service costs'

The adopted rule amendment governing the COGS deduction for indirect or administrative costs clarifies that a taxable entity may subtract as COGS service costs that it can demonstrate are reasonably allocable to the acquisition or production goods, up to 4% of total indirect and administrative overhead costs.

Service costs are further defined as "indirect labor costs and administrative overhead costs that can be identified 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 (including costs of recruiting, hiring, relocating, assigning, 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.

Taxes

The adopted rule also clarifies that property taxes paid on buildings and equipment used to acquire, produce, or store the goods are deductible as direct costs.

Election

The adopted rule memorializes the change in Comptroller policy (announced in 2012, read our summary here) that a taxable entity that initially computed its margin using the COGS method may file an amended report to change to the compensation deduction method; 70% of total revenue; or, if qualified, the E-Z computation method. Language new to the adopted rule allows taxpayers to change to the COGS method and allows the change in the election to occur as part of an audit.

The takeaway

With the expected enactment of H.B. 500 and the newly adopted amendments to the COGS rule, now is the time for taxpayers to review their current Texas margin tax calculation, previously filed returns, and previous audit adjustments for potential tax savings or refund claims. The rule amendment regarding labor costs represents a clarification of policy by the Comptroller as well as an effort to create consistency regarding the application of the rule to labor costs. Taxpayers, especially those that have been audited, should review which labor costs were included in their COGS calculation to identify potential refunds and/or exposure items.

Let's talk

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Other state tax development insights

The parenthetical indicates the development's PwC Insight published date

Multistate Tax Compact

200 years of interstate cooperation: Could a state tax case be the end? (April 15, 2013)

Multistate Tax Compact Update - Oregon repeals, re-enacts portions of the Compact (May 3, 2013)

State legislative and regulatory enactments

New Mexico

New law provides comprehensive tax reform (April 12, 2013)

Budget and legislative proposals

Federal

Senate passes Marketplace Fairness Act with amendment (May 8, 2013)

California

Revised budget proposes job creation and economic development changes (May 17, 2013)

Louisiana

Governor calls for state income tax phase-out (April 11, 2013)

North Carolina

Lawmakers consider comprehensive tax reform legislation (May 23, 2013)

Pennsylvania

House passes bill proposing significant income tax changes (May 10, 2013)

State adjustment powers

Massachusetts

Nexus creating transactions disregarded as sham transactions (May 31, 2013)

Nexus

California

In-state affiliates create nexus for financial securitization entities (May 24, 2013)

Iowa

Affiliate nexus enacted (June 14, 2013)

Kansas

Sales and use tax nexus expanded (April 19, 2013)

Maine

Affiliate and click-through nexus enacted (June 14, 2013)

New York

High court affirms facial constitutionality of remote seller law (April 5, 2013)

West Virginia

Affiliate nexus enacted (May 10, 2013)

Apportionment

California

Gross receipts were not excluded from sales factor as occasional sales (June 14, 2013)

Colorado

Alternative apportionment allowed for a bank's investment and trading receipts (April 19, 2013)

New Jersey

Proposed switch to market sourcing for service receipts (April 23, 2013)

Amnesty

Connecticut

Amnesty enacted (June 13, 2013)

Louisiana

Amnesty enacted (June 26, 2013)

Income tax rate

Connecticut

Surcharge extended (June 13, 2013)

Income tax credits

Texas

Research and development tax credit enacted (May 24, 2013)

Related party expenses

Kentucky

New law modifies management fee addback and adds use tax notification requirements (April 4, 2013)

Tennessee

Intangible expense compromise program extended (June 21, 2013)

Net operating losses

Indiana

Foreign source dividends are included in NOL calculation (April 5, 2013)

Other income tax developments

Multistate tax commission

MTC discontinues work on pass-through model statute (May 23, 2013)

California

California – Public hearing scheduled for DISA regulation (April 30, 2013)

Illinois

Illinois Supreme Court – Amnesty Double interest penalty applies to tax liability assessed following an IRS audit (June 21, 2013)

Massachusetts

Corporation properly classified as a financial institution (May 3, 2013)

New York

Retroactive application of credit changes is unconstitutional (June 12, 2013)

Texas

Compensation regulation invalid, benefit costs deductible for federal purposes may be included in franchise tax compensation deduction (April 5, 2013)

Other sales and use tax developments

Florida

Certain machinery and equipment exempt from sales and use tax (May 23, 2013)

Idaho

Idaho exempts cloud computing from sales tax (April 12, 2013)

Illinois

Illinois – Cook County amends use tax on non-titled tangible personal property (June 21, 2013)

Texas

Research and development sales and use tax exemption (May 24, 2013)

Abandoned and unclaimed property

Newsletter

Abandoned and Unclaimed Property Newsletter (May 24, 2013)

Credits and incentives

Enterprise zones

California Legislature approves sweeping changes to Enterprise Zone credit program (June 28, 2013)

Illinois – Enterprise zone sales tax exemption certificates expire, new certificates required on July 1, 2013 (June 12, 2013)

New markets tax credit

US Senate Bill proposes permanent extension of New Markets Tax Credit (June 20, 2013)

Federal budget proposes permanent reauthorization of New Markets Tax Credit (April 12, 2013)

New Markets Tax Credit – $3.5 billion of Community Development Entity allocations announced (April 24, 2013)

Employment tax

Employment tax insight

What should payroll tax departments focus on now that W-2 season is over? (May 6, 2013)

Let's talk

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