

Texas - Guidance provided regarding COGS changes

August 9, 2013

In brief

On July 16, 2013, the Comptroller's Office published an [internal memorandum](#) provided by the Tax Policy Division to the Audit Division to provide guidance regarding the state's recent revisions to its cost of goods sold (COGS) regulations. The memo explains the COGS treatment of indirect labor, service costs, property taxes, and certain benefit expenses. Taxpayers, especially those that have been audited, should review which of these costs were included in their COGS calculation to identify potential refunds and/or exposure items.

In detail

On May 16, 2013, the Comptroller adopted amendments to the COGS rule, allowing taxpayers to include as COGS those indirect labor costs, other than service costs, that are subject to capitalization.

[Click here](#) for our summary of the Comptroller's revised COGS rule.

Changes in the definition of labor costs

Prior to the rule change, the COGS deduction applied to *direct* labor costs (i.e., wages and benefits paid to individuals who physically produce or acquire goods). Supervisory labor costs were only allowed as an indirect or administrative cost (because supervisors do not directly 'touch' the goods) subject to the 4% cap.

The new rule generally provides that:

- Indirect labor is included within the COGS deduction.
- Service costs are included as COGS to the extent they relate to the acquisition or production of goods, but they are subject to the 4% cap.
- Costs that may be considered both indirect labor and services costs are subject to the 4% cap.

Indirect labor – included within COGS

Under prior audit policy, Comptroller auditors generally denied deductions for supervisory labor and other indirect labor, including labor related to engineers, management, and others not working directly on the production line. Auditors

required various types of documentation to prove that labor was direct.

Under the revised rule, deductible labor costs include *indirect labor costs*, which include labor costs (other than *service costs*) that can be directly attributed to production or resale activities (e.g., labor costs for production supervisors or project managers). This approach is based on IRC sec. 263A, which generally allows a deduction (when the ultimate product is sold) for certain indirect costs that "directly benefit, or are incurred by reason of, the performance of production or resale activities."

Service costs - indirect and administrative overhead costs

As noted above, *service costs* may be deducted as COGS but

they are subject to the 4% cap. Service costs are “indirect costs and administrative overhead costs,” which include service departments such as accounting, personnel, data processing, security, legal, and similar departments or functions.

The treatment of service costs is summarized as follows:

- Service costs demonstrably allocable to the acquisition or production of goods are included in the COGS deduction as indirect costs, subject to the 4% cap (which is a departure from federal treatment which has no cap).
- Service costs not allocable to the acquisition or production of goods may not be included in COGS, but are used to calculate the 4% cap. Costs that are specifically excluded

from COGS cannot be used to calculate the 4% cap.

As an example, a taxpayer’s internal legal department may prepare and review contracts for the production department, give tax advice to the tax department, and review sales contracts for the sales department. All of the associated legal costs become part of the 4% cap, but only those legal service costs relating to the production department are included in COGS as indirect costs, subject to the 4% cap.

Expanded scope of costs included in benefit expenses

In April 2013, a Texas district court found a margin tax regulation invalid to the extent that it prevents taxpayers from deducting as compensation certain benefit costs that are deductible for federal income tax

purposes. [Click here](#) for our summary of the *Winstead* decision.

The Comptroller recognized that the *Winstead* decision expanded the pool of costs that qualify as benefit expenses. Expenses such as job-related education, business use of a company car, out-of-town travel/meal reimbursements, and per diem payments may now be included in a taxpayer’s labor cost when the labor to which the benefits correspond is includable in COGS.

The takeaway

The Comptroller views the regulatory changes as aligning the state’s treatment of labor costs with federal treatment. The Comptroller believes that these revisions should result in less onerous audit documentation requirements and are more closely aligned with the statute.

Let’s talk

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

State and Local Tax Services

Scott Fischer
Partner, *Dallas*
+1 (214) 754-7589
scott.w.fischer@us.pwc.com

William Essay
Partner, *Houston*
+1 (713) 356-6050
william.j.essay@us.pwc.com

Paul Estrada
Principal, *Houston*
+1 (713) 356-8023
paul.estrada@us.pwc.com

Stephanie Stewart
Director, *Dallas*
+1 (214) 754-7429
stephanie.r.stewart@us.pwc.com

Rebecca Nelson
Director, *Dallas*
+1 (214) 954-5633
rebecca.f.nelson@us.pwc.com

Ron Rucker
Manager, *Houston*
+1 (713) 356-4389
ronald.j.rucker@us.pwc.com