

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

June 7, 2013

In brief

UPDATE: *H.B. 500 was signed by the governor on June 14, 2013*

House Bill 500, passed by the Texas Legislature and sent to Governor Perry for approval on May 28, 2013, 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, which is expected to be either signed into law by the governor or procedurally become law automatically within a few days, would take 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 expected 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

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

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