

Texas - Proposed rule change addresses COGS deduction for labor and service costs, reflects election policy change

March 20, 2013

In brief

The Texas Comptroller of Public Accounts proposed to amend its cost of goods sold (COGS) rule to allow 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 Regulations interpreting IRC §263A. Notably, the amendments would allow taxpayers that applied a more limited approach as to what labor costs are deductible to recalculate their deduction and consider filing for a refund. The proposed amendments also address the deduction for indirect or administrative overhead costs and reflect recent policy changes allowing taxpayers to change their computation method election on an amended return. [[34 TAC §3.588](#), [Texas Register](#), Volume 38. No. 11, 3/15/13]

In detail

Labor costs

Under the proposed 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 wages, temporary labor expenses, payroll taxes, pension contributions, and employee benefits expenses including per diem reimbursements for travel expenses.

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 proposed rule amendment governing the COGS deduction

for indirect or administrative costs clarifies that a taxable entity may subtract as COGS those service costs, including mixed service costs, which are allocable to the acquisition or production goods, up to 4% of total service 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, accounting, data processing, security, legal, and

similar departments. Service costs may include security services, legal services, data processing services, accounting services, accounts payable, disbursements, payroll functions, personnel operations such as recruiting, hiring, relocating, assigning, maintaining personnel records or employees, general financial planning and financial management costs.

Cost of Goods Sold election

The proposed regulation 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. The Comptroller's 2012 policy allowing taxpayers to change an originally filed return electing the compensation deduction method to a COGS deduction has not yet been proposed as a regulatory change but is expected.

The takeaway

The proposed 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. The Comptroller initially circulated draft proposals that would have limited the ability to claim labor costs as a deduction. The proposals released in the March register indicate the Comptroller's receptiveness to taxpayers' input.

Let's talk

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

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