

Texas Franchise Tax: New Sourcing Rule, COGS Calculations, Entity Issues, and Combined Reporting

TUESDAY, MAY 18, 2021, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION FOR THE LIVE PROGRAM

This program is approved for 2 CPE credit hours. To earn credit you must:

- **Participate in the program on your own computer connection (no sharing)** - if you need to register additional people, please call customer service at 1-800-926-7926 ext. 1 (or 404-881-1141 ext. 1). Strafford accepts American Express, Visa, MasterCard, Discover.
- Listen on-line via your computer speakers.
- Respond to five prompts during the program plus a single verification code.
- To earn full credit, you must remain connected for the entire program.

WHO TO CONTACT DURING THE LIVE PROGRAM

For Additional Registrations:

-Call Strafford Customer Service 1-800-926-7926 x1 (or 404-881-1141 x1)

For Assistance During the Live Program:

-On the web, use the Chat function to send a message

If you get disconnected during the program, you can simply log in using your original instructions and PIN.

Tips for Optimal Quality

FOR LIVE PROGRAM ONLY

Sound Quality

When listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, please e-mail sound@straffordpub.com immediately so we can address the problem.

Texas Franchise Tax: New Sourcing Rule, COGS Calculations, Entity Issues, and Combined Reporting

May 18, 2021

Jamie Bowden
Senior Manager, Indirect Tax Services
Ernst & Young
jamie.bowden@ey.com

Bill Crow, JD
Managing Partner
Energy Tax Advisors
bcrow@energytaxadvisors.com

Christina A. Mondrik, Esq., CPA
Attorney
Mondrik & Associates
cmondrik@mondriklaw.com

Notice

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS' FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

Strafford Live CPE Webinars

Texas Franchise Tax:

New Sourcing Rule, COGS Calculations,
Entity Issues, and Combined Reporting

May 18, 2021

Speakers



Jamie Bowden, JD, CPA

Ernst & Young



Christina A. Mondrik, Esq., CPA

Mondrik & Associates



Bill Crow, JD

Energy Tax Advisors



Mondrik & Associates



Agenda

- Introduction
- January 2021 Amendments to 34 Tex. Admin. Code Section 3.591
- Margin Tax Calculation Options
- Issues in Computing Revenues (PPP)
- Retail / Wholesale Tax Rate
- Cost of Goods Sold Deduction
- Combined Reporting and Affiliated Entities – Unitary
- Other Recent Developments – R&D Tax Credit
- Questions

Introduction: Is it a Franchise, Income or Margin Tax?

- Is There a Reason Texas Has to be so Unconventional?
- The Texas Constitution, Article VIII, Section 24. “PERSONAL INCOME TAX; DEDICATION OF PROCEEDS” provides:

A general law enacted by the legislature that **imposes a tax on the net incomes of natural persons**, including a person's share of partnership and unincorporated association income, must provide that the portion of the law imposing the tax not take effect until approved by a majority of the registered voters voting in a statewide referendum held on the question of imposing the tax. The referendum must specify the rate of the tax that will apply to taxable income as defined by law.
- Legislature Cannot Unilaterally Impose Income Tax on Natural Persons
- Why Texas had a “Franchise” Tax on “taxable capital” and “earned surplus” until the “Revised” Franchise Tax passed in 2006
- Also why that “Revised” Franchise Tax is imposed on “Margin” and not “Net Income” (and also NOT on general partnerships owned 100% by “Natural Persons”)
- Are the Skeptics Correct? Is “Margin” just a Euphemism for “Net Income” (like “earned surplus” before it)?

Introduction: Other Texas Franchise Tax Oddities

- Did we mention “Margin”?
- Public Law 86-272 Protection:
 - Remember That “Income Tax” Slide?
 - Texas - it does not apply [Rule 3.586(i)]
- “Report Year” v. “Tax Year”, etc.
 - Equals year report filed not year being reported (i.e., 2021 Report Year reports 2020 activity)
- Combined Group – *Joyce* state, Member with No-Nexus, Texas receipts not included in Apportionment Calc.
- 2 Extensions? [8/15, 11/15] – just for EFT filers. Who came up with that?

Introduction: Other Texas Franchise Tax Oddities

- 3 Different Forms – Just for the Tax Calculation
- 4 Different Ways to Calculate “Margin”
- 3 Different Tax Rates
- Apportionment – Changes, but still, what the heck is a “Location of Payor”? Is that from the Magna Carta? Now Defined as “the Legal Domicile of the Payor”.
- EFT – FUNDS OVER \$25,000 (must be initiated by 8pm the day before the due date – it takes longer to count big numbers!)
- Public Information Report?

Introduction: Margin Tax Basics

- Virtually all entities subject to tax, including limited partnerships
- Generally, based on total revenues minus costs of goods sold or compensation (capped at \$390,000 per individual for report year 2021)
- Mandatory unitary combined reporting
- Single gross receipts factor
- Tax rate 0.75% (1.00%-0.95%, prior to 2016) for most businesses; 0.375% (0.50%- 0.475% prior to 2016) for retailers and wholesalers
- Many special rules

Introduction: Who Pays? Entities Subject to Tax

Tax imposed on each “taxable entity” doing business or chartered and organized in the state including, but not limited to (legal form, not federal classification):

- Partnerships (including General)
- Corporations (including S Corps, PCs)
- Banking (Corps, Associations, S&Ls)
- Limited Liability Companies
- Business Trusts and Associations
- Joint Ventures
- Holding Companies

Introduction: Who Pays? Entities NOT Subject to Tax

Includes:

- Most sole proprietorships (not disregarded LLCs)
- General partnerships owned entirely by natural persons (except LLPs)
- Unincorporated Passive Entities (as defined)
- Certain REITS and qualified REIT subsidiaries
- Real estate mortgage investment conduits
- Certain Grantor Trusts, Estates of Natural Persons
- Certain other entities per Tex. Tax Code 171.0002(b)
-  **NEW:** Veteran-Owned Businesses (for 5 Years)
- ***“Tax on the Net Incomes of Natural Persons”? JUST IN CASE...***

January 2021 Amendments to
34 Tex. Admin. Code Section
3.591

Apportionment

- Margin is apportioned by gross receipts
- EZ computation is also apportioned by gross receipts
- Texas gross receipts / Everywhere gross receipts
- Gross receipts \approx Revenues

Comptroller Rule 3.591

- General Rules
 - Tangible personal property
 - Real property
 - Location of payor for “intangibles”

Comptroller Rule 3.591 (2021 revision)

- Terminology changes in 1.15.2021 amendments:
 - Intangibles → Intangible assets
 - Receipts → Gross receipts
 - Gross receipts everywhere → Gross receipts from an entity's entire business
 - Apportioned → Sourced
 - Legal domicile of payor → Location of payor
 - Revenue → Gross receipts

Comptroller Rule 3.591 (2021 revision)

- Definition changes in 1.15.2021 amendments:
 - Capital asset (b)(1) → Removes circular language with investment (b)(6)
 - Commercial domicile (b)(2) → definition removed
 - Gross receipts → definition amended to reflect certain non-receipt items are excluded when calculating total revenue are added back for gross receipts
 - \$500 per pro bono case for attorneys
 - Actual cost of uncompensated care
 - Direct cost of waterway transportation
 - Direct cost of agricultural aircraft services
 - Cost of a vaccine
 - Internal Revenue Code → clarifying it is the federal tax year beginning January 1, 2007

Comptroller Rule 3.591 (2021 revision)

- Definition changes in 1.15.2021 amendments:
 - Inventory
 - Investment
 - Legal domicile
 - Principal place of business
 - Regulated investment company
 - Texas gross receipts
 - Employee retirement plan

Hallmark Marketing Co. v. Combs

Cause No. 13-14-00093-CV (Tex. App.—Corpus Christi-Edinburg 2014) (mem. op), *rev'd on other grounds*, 488 S.W.3d 795 (Tex. 2016)

- Total gross receipts
- Investment and capital losses
- Comptroller Rule: “net gain” = “net loss”
 - Appeals Court: “The ambiguity arises because it is unclear, by examining only the plain language of the statute, what the term ‘net gain’ means. ...”
 - Texas Supreme Court: “we do not need to relitigate the question in order to determine Hallmark did not have a net gain under any calculation.”
- Result: Netting not applied to apportionment denominator

Comptroller Rule 3.591 (2021 revision)

- Net gain = net amount resulting from proceeds of an asset sale reduced by the adjusted basis in the assets
- Statute only permits inclusion of net gains
- Net loss from sale of one asset cannot be used to offset net gain from another asset

Comptroller Rule 3.591 (2021 revision)

- New sourcing rules for Computer Hardware and Digital Property
 - Replaces receipts from sale of computer software services and programs
 - Sale or lease of software installed on computer hardware is treated as part of the sale or lease of computer hardware
 - Sale or lease of digital property on fixed media is treated as the sale or lease of tangible personal property.
 - Sale of digital property not on fixed media → intangible property → location of payor rule
 - Receipts from delivery of digital property as a service → sourced as a service
 - Receipts from use of digital property → receipts from use of an intangible asset

Comptroller Rule 3.591 (2021 revision)

- New definition of digital property
 - Computer programs and any content in digital format that is either protected by copyright law or no longer protected by copyright law solely due to the passage of time
- Customer's location
 - Physical location where purchaser or designee consumes service
 - Good faith determination; most reasonable method under circumstances:
 - Principal place of business
 - Customer's business unit
 - Delivery addresses for individual units of service
 - Primary place or places of consumption
 - Customer's service address
 - Customer's billing address
 - Combination of methods

Comptroller Rule 3.591 (2021 revision)

- Purchase of access over internet to computer services is distinguished from purchase or lease of computer hardware or digital property. Relevant factors:
 - Customer not in physical possession of property
 - Customer does not control property, beyond network access and use
 - Provider retains right to determine specific property used in transaction and replace it with comparable property
 - Property is component of integrated operation in which provider has other responsibilities, ensuring property is maintained and updated
 - Customer does not have significant economic or possessory interest in property
 - Provider bears risk of substantially diminished receipts or substantially increased expenses for nonperformance under contract
 - Provider uses property concurrently to provide significant services to unrelated entities
 - Provider's fee based primarily on measure of work performed or level of customers' use rather than mere passage of time
 - Contract price substantially exceeds rental value for contract period

Comptroller Rule 3.591 (2021 revision)

- Internet hosting services
 - Texas gross receipts if customer is located in Texas (eff. 1/1/2014)
 - Providing unrelated user access via internet to computer services using property owned or leased and managed by provider on which user may stored or process its own data or use software owned, licensed or leased by user or provider
 - Real-time, nearly real time, and on-demand access to: data storage/retrieval; video gaming; database search; entertainment streaming; data processing; marketplace provider service; etc.
 - Does not include: telecommunications; cable television; internet connectivity; internet advertising; or internet access solely to download digital

TGS-NOPEC Geophysical v. Combs

268 S.W.3d 637 (Tex. App.—Austin 2008)

- Seismic data licensing receipts
- Apportioned by location of payor
- Comptroller recharacterized as apportionable to Texas (licenses used in Texas)
- Recharacterization conflicted with rule

Comptroller Rule 3.591 (2021 revision)

- Patents, copyrights, and other intangible assets
 - Gross receipts from use of intangibles
 - Texas gross receipts from patent royalties used in Texas
 - Texas gross receipts from copyright royalties used in printing or publication in Texas
 - Applies to receipts owner of a patent, copyrighted material, trademark, franchise, or license receives from licensing the use of that item in Texas
 - Royalties from affiliates not transacting substantial portion of business or regularly maintaining a substantial portion of assets in US are excluded from Texas gross receipts and gross receipts from everywhere
 - Examples
 - Seismic data license
 - Inventor licensing patent to manufacturer
 - Copyright owner licenses publication

Comptroller Rule 3.591 (2021 revision)

- Consolidation of receipts from advertising
 - Newspapers
 - Magazines
 - Radio / Television
 - Other media
- Rule 3.591 (e)(1): sourced to locations of advertising audience
 - Good faith; most reasonable method under circumstances
 - Books and records
 - Receipt-producing. end-product act
 - If nationwide and not reasonably determined, 8.7% sourced to Texas

Comptroller Rule 3.591 (2021 revision)

- Services
 - Each service performed in Texas
 - Not necessarily service benefit location
 - Servicing loans on real property apportioned by real property's location

Hegar v. Sirius XM Radio, Inc.

(Tex. App.—Austin 2020) Cause No. 03-18-00573-CV (Texas Supreme Court Case No. 20-0462)

- Programs produced primarily outside Texas
- Subsidies paid to car manufacturers
- Issue 1: What is the receipt-producing end-product act?
 - Producing programs or activating receivers?
- Issue 2: Are radio programs “goods”?
 - Subscribers receive right to access content.
- On petition to Texas Supreme Court for review

Comptroller Rule 3.591 (2021 revision)

- Performance of service: receipts-producing, end-product act
 - Admission fees, subscription fees, live or pre-recorded (where recipients observe)
 - Architectural design of structure (where architect performed work)
 - Sale of house book plans → sourced as tangible personal property
 - Law firm in TX and LA
 - Hourly billing – work in TX apportioned to TX
 - Flat fee – apportioned based on hours worked
 - Landscaper providing work in 4 TX locations and 1 OK location
 - Annual fee
 - Apportioned 4/5 to TX

Comptroller Rule 3.591 (2021 revision)

- Special rules
 - Regulated investment companies
 - Employee retirement plans
 - Defense readjustment zones
- Sale of SMLLC – location of payor
- Subsidy or grant – where service performed
- Telecommunications
- Broadcasting
- Natural gas

Comptroller Rule 3.591 (2021 revision)

- Transportation
 - Transport of goods or passengers originating and terminating in Texas or
 - Ratio of total compensated miles for transporting goods and passengers in Texas to total miles

Lockheed Martin Corp. v. Hegar

63 Tex. Sup. T.J. 959 (2020)

- Texas franchise tax intersects with federal laws restricting export of military articles from US to other nations
- Foreign Military Sales (FMS)
- Receipts sourced out-of-state:
 - Sales made through US Government
 - Government pilot picked up jets in Fort Worth
 - Ultimate sale was out-of-state to foreign military

Margin Tax Calculation Options

Margin Tax Calculation – General Computation of Tax (Lesser of...)

- Margin = “Total Revenue” minus
 - Cost of Goods Sold OR
 - Compensation OR
 - 30% of Total Revenue OR
 - \$1 Million
- Smallest Margin Wins (best answer for taxpayer)
- Margin is Pre-Appportionment – After Margin, apportionment to arrive at “Apportioned Margin”

Margin Tax Calculation – No Tax Due, EZ Computation, Minimum Tax

- No-Tax-Due Threshold (Form 05-163, must e-file):
 - Began at \$300,000 (2008/09 Report Years)
 - Increased to \$1,000,000 (2010/11 Report Years)
 - Then incrementally to \$1,180,000 (2021 Report Year)
- E-Z Computation (Form 05-169) - Combined groups with total revenue of less than or equal to \$20 million may elect to pay a gross receipts tax
 - Computation:

Total Revenue
x Apportionment Factor
x .331%
Franchise Tax Due
 - May subtract applicable discount (no credits)
- NO Minimum Tax
- But - Tax is \$0 if Calculated Tax is under \$1,000

Margin Tax Calculation – Computation of Tax Key Points

- Total revenue generally based on federal entity classification
- Each term is statutorily defined
 - Example-Costs of goods sold does not follow Treas. Reg. 1.263A-1
 - Certain items included for federal may not be included for Texas purposes
- Election to deduct costs of goods sold or compensation made on annual report
 - Timing
 - Can be changed each year
 - Entities filing a combined report must make a single election for the combined group

Margin Tax Calculation – How/When? Other Provisions – Filing Date

- Due date:
 - May 15th, (June 15th for 2021) if no extension (if first extension to 8-15, must pay 90% of current tax or 100% of prior year)
 - August 15th, if proper first extension (if second extension to 11-15, must pay 100% of current year)
 - November 15th (if proper second extension for EFT filer, *only extended date for non-EFT*)
- Second extension required for taxpayers with mandatory EFT payments (most taxpayers - \$10,000 or more in franchise tax)
- “Properly Extended”
- Fiscal Year Taxpayers – Due Date? Same.

Issues in Computing Revenues

Issues in Computing Revenues

- Rule 3.586(f) Economic nexus
 - \$500,000 receipts from business done in Texas
 - January 1, 2020
 - All revenue reportable by a taxable entity on its federal return
 - No deduction for COGS, materials, labor, etc.
- Rule 3.586(d) nexus
 - Teleworkers in Texas
 - Even if below \$500,000
- Federal gross receipts
 - Reported v. reportable

Issues in Computing Revenues

- PPP loan proceeds
 - Federal loan forgiveness
 - Expenses deductible (Rev. Rul. 2021-2)
- Texas Tax Code § 171.1011(9) incorporates Internal Revenue Code as of January 1, 2007 without subsequent changes
- HB 1195 (2021) excludes from revenue forgiven loans from
 - CARES Act amended by PPP Flexibility Act and CAA 2021 microloan program recovery assistance
 - American Rescue Plan Act of 2021 restaurant revitalization funds
- Applicable expenses allowed in calculating COGS / Compensation

Retailer / Wholesaler Tax Rate

Retail / Wholesale Tax Rates

- Rate is 0.75% of taxable margin or 0.375% for those entities primarily engaged in retail or wholesale trade
- Who qualifies for the retail / wholesale rate
- The Comptroller revised rule - 34 Tex. Admin. Code Section 3.584 (August 30, 2019)
- A taxable entity is primarily engaged in retail or wholesale trade only if:
 - Total revenue from its activities in retail or wholesale trade is greater than the total revenue from its activities in other trades;
 - Less than 50% of the total revenue from activities in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs; and
 - The taxable entity does not provide retail or wholesale utilities, including telecommunications services, electricity, or gas
- Unrelated party- anyone not part of the taxpayer's combined group
 - Affiliated group - entities in which a controlling interest is owned by a common owner, either corporate or noncorporate, or by one or more of the member entities (34 Tex. Admin. Code 3.590(b)(1))
 - Affiliated Group may include entities not part of the combined group (i.e., foreign affiliates)

Retail / Wholesale Tax Rates

- Produce - To construct, manufacture, install during the manufacturing or construction process, develop, mine, extract, improve, create, raise, or grow either a product or a component of a product.
 - Software Copyright
 - Patent on product, component of product, or the packaging of the product
 - Modification – does not increase the sales price of the product by more than 10%
- 3rd party Contract Manufacturers
- Retail Trade / Wholesalers
 - (i) the activities described in Division G of the SIC Manual;
 - (ii) apparel rental activities classified as Industry 5999 or 7299 of the SIC Manual;
 - (iii) the activities classified as Automotive Repair Shops, Industry Group 753 of the SIC Manual;
 - (iv) rental-purchase agreement activities regulated by Business & Commerce Code, Chapter 92;
 - (v) rental or leasing of tools, party and event supplies, and furniture, classified as Industry 7359 of the SIC Manual; and
 - (vi) heavy construction equipment rental or leasing activities, classified as Industry 7353 of the SIC Manual.
 - (6) SIC Manual--The 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget.
 - (7) Wholesale trade--The activities described in Division F of the SIC Manual.

Cost of Goods Sold Deduction

Cost of Goods Sold Deduction

- Texas does not follow the federal COGS deduction
- Who qualifies?
 - In general must sell a good
 - Goods – real or tangible personal property sold in the ordinary course of business
 - Tangible Personal Property is defined
 - personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner;
 - 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
 - a computer program, as defined in paragraph (2) of this subsection
 - Tangible Personal Property does not include
 - intangible property
 - services

Cost of Goods Sold Deduction

- Includable COGS expenses:
 - Direct Costs include all direct costs of acquiring or producing the goods. Direct costs include (but not limited to):
 - Handling
 - Storage
 - R&D costs
 - Depreciation (no bonus)
 - Production related costs
 - Production - construction, manufacture, installation occurring during the manufacturing or construction process, development, mining, extraction, improvement, creation, raising, or growth
 - Indirect – A taxable entity may subtract as a cost of goods sold indirect or administrative overhead costs that it can demonstrate are allocable to the acquisition or production of goods, subject to the 4% limitation
 - Mixed costs
 - 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
 - Time motion study / allocations

Cost of Goods Sold Deduction

- Vendor funded incentives
 - Excluded from COGS deduction
 - Advertising
 - Coupon Program-Handling fees
 - Product Demos
 - Product Placement
 - Shows/Seminar
 - Included in the COGS deduction
 - Coupon Program-Face Value
 - Depletion Allowance/Volume Incentives
 - Mark Down Funding
 - New Item Allowances
 - Sales Based Incentives
 - Temporary Price Reductions

Cost of Goods Sold Deduction

- Excludable costs include but not limited:
 - Rent/ lease of property not used in production
 - Selling costs
 - Distribution costs
 - Advertising costs
 - Idle facility expense
 - Rehandling costs
 - Bidding costs
 - Interest expense
 - Strike expenses
 - Officer's compensation
 - Certain government property expenses
 - Undocumented worker compensation used for the production of goods

Cost of Goods Sold Deduction

- Special provisions for certain industries under Tex. Tax Code Section 171.1012 including:
 - Real property improvement (Subsection (i))
 - Renting or leasing of motor vehicles, heavy construction, and railcar rolling stock (Subsection (k-1))
 - Pipeline entity (Subsection (k-2)) 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
 - 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
 - Film/Television production, broadcasting, or distribution of tangible personal property described in Subsection (a)(3)(A)(ii)... (Subsection (0))
 - Movie theaters (Subsection (t))

Recent Franchise Tax Litigation - Texas Cost of Goods Sold Deduction

- Texas Cost of Goods Sold Deduction
 - Three Supreme Court of Texas Opinions relating to COGS issued April 3, 2020
 - *Sunstate Equipment Co., LLC v. Hegar*
 - *Hegar v. Gulf Copper & Manufacturing Corporation*
 - *Hegar v. American Multi-Cinema, Inc.*
 - Background
 - Historically there has been litigation around the Texas COGS deduction
 - Oral arguments occurred on the same day
 - Opinions were intertwined to clarify terms in the COGS statute
 - High-level Summary of Opinions
 - The Court primarily ruled against the Taxpayer related to COGS
 - Positive Taxpayer Outcomes
 - Burden of proof
 - Term's defined
 - Revenue exclusion

Recent Franchise Tax Litigation - Texas Cost of Goods Sold Deduction

- ***Sunstate Equipment Co., LLC v. Hegar***
 - Supreme Court of Texas held that a heavy construction rental company could not deduct equipment delivery and pick up costs as a part of its COGS deduction
 - Texas Tax Code § 171.1012(k-1)
 - Subsection (k-1) allows certain entities to subtract costs “in relation to tangible personal property that the entity rents or leases in the ordinary course of business.”
 - This subsection does not expand COGS provision.
 - Heavy construction equipment rental or leasing company can subtract as COGS those costs otherwise allowed by other provisions of §171.1012.
- Clarification of terms in §171.1012 could impact other taxpayers
- Texas Tax Code §171.1012(i)
 - Court held labor was not furnished to a project for the construction or improvement of real property.

Recent Franchise Tax Litigation - Texas Cost of Goods Sold Deduction

- ***Hegar v. Gulf Copper & Manufacturing Corporation***
 - Company used subcontractors to survey, repair, and upgrade offshore oil and gas rigs for rig owners and drilling contractors who in turn use the rigs to drill offshore wells
 - Subcontractor payments excluded from total revenue for Texas franchise tax purposes under Texas Tax Code §171.1011(g)(3)
- Narrow interpretation of Texas Tax Code §171.1012(i)
 - Costs did not qualify as construction or repair of real property as defined in Texas Tax Code §171.1012(i)
- Taxpayer cannot build COGS deduction from federal return

Recent Franchise Tax Litigation - Texas Cost of Goods Sold Deduction

- ***Hegar v. American Multi-Cinema, Inc.***
 - AMC sought to exclude film exhibition costs from COGS
 - Court held film acquisition costs and costs associated with theater auditoriums were not allowable in COGS deduction
 - To qualify as COGS in Texas, the cost must relate to tangible personal property that is sold in the ordinary course of the taxable entity's business
 - Film exhibitions are not personal property subject to ownership
 - A sale requires some transfer of property or title in exchange for value
- Beginning in 2013, Texas Tax Code § 171.1012(t) expressly allows movie theatres to subtract exhibition costs as COGS
- Change in Texas Tax Code § 171.1012(t) was not a clarification of law
- ***Hegar v. Sirius XM Radio, Inc.*** - Cost of Goods Sold
 - Sirius XM sought to include revenue share and hardware subsidies paid to automobile manufacturers to install satellite enabled radios in their Texas cost of goods sold deduction

Combined Reporting and Affiliated Entities - Unitary

Combined Reporting and Affiliated Entities

Rule 3.590:

(b) Definitions.

(1) Affiliated group--Entities in which a controlling interest is owned by a common owner, either corporate or noncorporate, or by one or more of the member entities.

(2) Combined group--Taxable entities that are part of an affiliated group engaged in a unitary business and that are required to file a combined group report under Tax Code, §171.1014.

Combined Reporting and Affiliated Entities- Includes “Taxable Entities” that are:

1. Affiliated Entities – Even if No Nexus
 - > 50% of Voting or Beneficial/Economic Interests
 - Direct or Indirect
 - Pass-Through and Disregarded Entities (Not Federal Consolidation rules)

2. Domestic Entities
 - Not 80% or more of property/payroll outside US

3. Unitary Entities
 - Presumption
 - Texas and U.S. Constitutional Analysis

Combined Reporting and Affiliated Entities

- Reporting Entity:
 - Parent or
 - Entity in the combined group with Texas nexus and “greatest Texas business activity during the first period upon which the first report is based, as measured by the Texas receipts after eliminations for that period.”

Combined Reporting and Affiliated Entities- Unitary Group

- Mandatory
- Presumption of unity – Rebuttable
- Multiple Groups (Potentially)
- One deduction choice (COGS, Comp., etc.)
- Joint and Several Liability
- *Joyce State:*
 - No-nexus member, Texas sales for apportionment excluded from group numerator.
 - Exception - Unitary Group Sales Company with no Texas nexus – Texas sales included

Combined Reporting and Affiliated Entities- Unitary Business Analysis

Rule 3.590:

(b)(6) Unitary Business - A single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. In determining whether a unitary business exists, the comptroller shall consider any relevant factor, including:

(A) whether:

NEXT PAGE

Combined Reporting and Affiliated Entities- Unitary Business Analysis

(i) activities of the group members are in the same general line, such as manufacturing, wholesaling, retailing of tangible personal property, transportation, or finance;

(ii) the activities of the group members are steps in a vertically structured enterprise or process, such as the steps involved in the production of natural resources, including exploration, mining, refining, and marketing; or

(iii) the members are functionally integrated through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing.

(B) Other factors. In addition, the comptroller may consider other factors that may be applicable, including guidelines in Supreme Court decisions that presume activities are unitary. All affiliated entities are presumed to be engaged in a unitary business.

Combined Reporting and Affiliated Entities- Unitary Business Analysis - Hearings

Texas Comptroller Hearing Nos. 111,577-111,580 (October 2015)

- Entities Not Unitary Because of the Lack of “**Strong**” Centralized Government
- Facts Supporting: Separate lines of business, Not Day-to-Day management by ownership, No Common Employees

Texas Comptroller Hearing No. 110,062 (November 2014)

- Limitations not tolled if Refunds filed via improper Change in Filing Format
- Invalid Separate Company amended returns of a validly filed Combined Report.

Texas Comptroller Hearing No. 116,723 (April 2020)

- Taxpayer operating 2 different restaurant chains found to be unitary (taxpayer failed to overcome unitary presumption)
- “In addition, the entities are in the same general line of business, share officers and directors, and appear to be controlled by the same centralized management.”

Other Recent Developments –
R&D Tax Credit

Texas Franchise Tax: Research and Development Credit

- Two options to utilize tax benefit generated
 - Franchise Tax Credit
 - Limited to 50% of Franchise Tax Liability
 - Sales and Use Tax Exemption
 - Depreciable tangible personal property with 1+ year depreciable life
 - Purchase, lease, rental, storage, or use on qualifying research
- On April 16, 2021, the Comptroller issued proposed amendments to its franchise tax rule, 34 Tex. Admin. Code Section 3.599 and 34 Tex. Admin. Code Section 3.340, regarding the tax credit for research and development (R&D) activities for franchise tax and sales and use tax
 - The proposed amendments, if adopted, would be retroactively effective for Texas franchise tax reports originally due on or after January 1, 2014
 - Comments on the proposed amendments to both the Texas franchise and sales and use tax rules are due May 16, 2021

Texas Franchise Tax: Research and Development Credit

- The proposed franchise tax amendments would make significant changes to 34 Tex. Admin. Code Section 3.599 (Rule 3.599), including:
 - Incorporating, in general, the four-part test for the federal research credit articulated in IRC Section 41(d)
 - Amending the definition of qualified research expense to mean the sum of all in-house research and contract research expenses
 - Clarifying that the applicable reference to the IRC for R&D credit purposes would be the IRC in effect as of December 31, 2011, and specifying that any federal regulation adopted after this date is only included in this term to the extent a taxpayer must apply that regulation in the 2011 tax year
 - Listing activities that would not constitute qualified research activities (such as “internal-use software”)
 - Clarifying that tangible personal property would not qualify as a research expense for purposes of the TX R&D credit if the taxpayer claimed a manufacturing or resale sales tax exemption when purchasing that property
 - Modifying credit eligibility requirements
 - Providing guidance to TX franchise tax combined groups claiming the TX R&D credit

Texas Franchise Tax: Research and Development Credit

- Excluded activities under the proposed Rule 3.599 would include:
 - Research after commercial production of the business component
 - Adaptation of existing business components
 - Duplication of existing business components
 - Surveys, studies, market research, etc.
 - Internal-use computer software
 - Social sciences, arts or humanities
 - Research funded by a grant, contract or by another person or governmental entity
- Credit eligibility requirements
 - The proposed amendment would add a provision explaining that the taxable entity has the burden of establishing its entitlement to, and the value of, the credit by clear and convincing evidence
 - The proposed amendment would further require:
 - all qualified research expenses to be paid or incurred in connection with qualified research activities;
and
 - all qualified research expenses to be supported by contemporaneous business records

Texas Franchise Tax: Research and Development Credit

- Other changes under the proposed Rule 3.599 would include:
 - Each member of a combined group determines its credit as if it were an individual taxable entity with the total credits for each entity added together to determine the credit claimed on the combined report
 - Each member of the combined group may claim a portion of the credit carryforward corresponding to the credit amount that member generated (the member could still claim the portion of the credit even if it became a member of a different combined group)
 - The rate for qualified research expenses under a higher education contract would apply to each member of the combined group separately and not the group as a whole
 - Eligibility for the credit would be determined by each member of the group as if it were an individual taxable entity
 - If a credit were carried forward, the TX Comptroller could verify that the credit creating the carryforward was based on qualified research activities, even if the statute of limitations has expired for the year of the credit's creation. This verification would not result in an adjustment to tax, penalty or interest for any report year for which the statute of limitations has expired but could result in the adjustment to the carryforward for all open and future periods

Texas Franchise Tax: Research and Development Credit – Audit Procedures

- Review of R&D Credit
 - QRA's
 - QRE's
- Sampling Procedures
- Certain Industries Scrutinized

Questions

