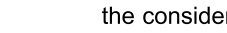
The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

Filed with the Office of the Secretary of State on February 28, 2018.

TRD-201800865
William Hamner
Special Counsel for Tax Administration
Comptroller of Public Accounts
Effective date: March 20, 2018
Proposal publication date: January 26, 2018
For further information, please call: (512) 475-0387



SUBCHAPTER V. FRANCHISE TAX

34 TAC §3.588

The Comptroller of Public Accounts adopts amendments to §3.588, concerning margin: cost of goods sold, with changes to the proposed text as published in the September 29, 2017, issue of the *Texas Register* (42 TexReg 5235).

The comptroller amends the section to implement House Bill 500, 83rd Legislature, 2013. The changes also add definitions and interpret ambiguous statutory language.

The comptroller received comments regarding the proposed amendments from the Associated General Contractors- Texas Building Branch (AGC-TBB); David Gilliland of Duggins Wren Mann & Romero, LLP, Attorneys at Law; Jimmy Martens of Martens, Todd, Leonard & Ahlrich, Attorneys at Law; and the State Bar of Texas, Tax Section (State Bar).

Mr. Martens requested a public hearing on the proposed amendments. The comptroller declines to conduct a public hearing, as the request does not meet the requirements of Government Code §2001.029(b) (Public Comment). The State Bar requested a roundtable discussion. The comptroller declines to hold a roundtable discussion at this time.

The comptroller amends subsection (a) to indicate that specific provisions of this section apply to reports other than those originally due on or after January 1, 2008.

The comptroller amends subsection (c) to add new paragraph (8) concerning movie theaters. New paragraph (8) implements House Bill 500, Section 10, which enacted Tax Code, §171.1012(t), effective September 1, 2013. The language in this paragraph mirrors the statutory language except as noted below in response to comments received. Subsequent paragraphs are renumbered accordingly.

The State Bar requests the addition of the phrase "in addition to costs otherwise allowed by this section" to the language in subsection (c)(8). The State Bar takes the position that the costs a movie theater may include in its cost of goods sold calculation are not limited to the items listed in Tax Code, §171.1012(t). The comptroller agrees in part and amends the subsection to state that movie theaters may also include the costs of concessions as costs of goods sold.

The comptroller amends renumbered paragraph (9), which implements Tax Code, §171.1012(i), concerning the ownership of goods, to add a presumption that the legal title holder is the owner of the goods and to define several additional terms that are used in the current paragraph.

Paragraph (9) is reorganized to add new subparagraph (A). Existing language for determining when a taxable entity is the owner of goods is located in new subparagraph (A). The comptroller amends the existing language to add a rebuttable presumption that the legal title holder is the owner of the goods. A taxpayer may rebut the presumption by proving an ownership right superior to the legal title holder.

In written comments, the State Bar, Mr. Martens, and Mr. Gilliland request the removal of the proposed rebuttable presumption of ownership from subsection (c)(9)(A). They argue that the presumption is contrary to the legislature's intent and inconsistent with the language in §171.1012(i), which requires the consideration of "all factors and circumstance" in the determination of ownership. The comptroller appreciates the points made in these comments, but has determined the proposed language is necessary to ensure that multiple taxable entities do not claim ownership and are therefore eligible to deduct costs of goods sold with respect to the same goods. The comptroller therefore declines to make the requested change.

The comptroller proposed amending relettered subparagraph (B) to define the terms "labor," "material," and "project" for purposes of paragraph (9) only. The proposed amendment used the definitions of "labor" and "material" verbatim from Property Code, §53.001 (3) and (4) (Definitions), except that the proposed amendment replaces the term "work" with the term "project." The definition of "project" tracked the language of Tax Code, §171.1012(i).

Tax Code, §171.1012(i) states that a taxable entity "furnishing labor and materials to a project" is considered to be the owner of the labor and materials and may include the costs as allowed by §171.1012 in the computation of cost of goods sold. However, §171.1012(i) does not define "labor" or "materials." The lack of definitions has created uncertainty and generated numerous controversies. The courts have held that a contractor may claim labor and material costs if they are "an essential and direct" component of a project but not if they are "too far removed" from the project. Combs v. Newpark Resources, Inc., 422 S.W.3d 46, 57 (Tex. App.- Austin 2013, no pet.); Hegar v. CGG Veritas Services (U.S.), Inc., No. 03-14-00713-CV (Tex. App.- Austin 2016, no pet.) (mem. op.).

The boundaries between "essential and direct" and "too far removed" are uncertain. To reduce the uncertainty, the comptroller proposes to add definitions of "labor" and "materials" based on the definitions used in Texas Property Code, Chapter 53 (Mechanic's, Contractor's, or Materialman's Lien). The Tax Code phrase "furnishing labor and materials" is similar to the Property Code phrase "furnishes labor and materials." Therefore, it is reasonable to assume that the Legislature intended similar definitions.

The comptroller will consider case law interpreting Property Code, Chapter 53, but may adapt Property Code interpretations to conform to needs of the Tax Code. Because the proposed amendment requires that the labor and materials be used in the "direct prosecution" of a project and the franchise tax case law requires that the labor and material be "direct and essential" components of a project, the proposed amendments are generally consistent with the direction given by the courts. However, outcomes could vary depending upon the facts. For example, it is conceivable that a seismic surveyor's work could

be performed in the direct prosecution of a particular drilling project so that the surveyor could obtain a lien on the project. In that instance, the tax outcome would be consistent with the outcome of the CGG Veritas court decision. On the other hand, it is also conceivable that a seismic surveyor's work could be performed generically so that the surveyor could not obtain a lien on a particular project. In that instance, the tax outcome might be inconsistent with the outcome of the CGG Veritas court decision. The court decision did not discuss the ability of CGG Veritas to obtain a lien.

Finally, these definitions, which require that the labor and materials be used in the "direct prosecution" of the project, are limited to the determination of whether the taxable entity furnishing the labor and materials is considered to be an "owner" under §171.1012(i), and do not affect the determination of allowable costs under other subsections. For example, these definitions do not apply to direct labor costs described under subsection (d)(1) of this section.

With respect to the proposed amendments to subsection (c)(9)(B), AGC-TBB asks the comptroller to modify the second sentence concerning determination of ownership of labor and materials by adding the words "the sole" before the word "purpose" and deleting the phrase "related to that labor and materials." The comptroller agrees in part. The comptroller declines to add the phrase "the sole," since the phrase neither adds nor subtracts from the meaning of the sentence. However, the comptroller agrees to delete the phrase "related to that labor and materials."

The State Bar requests the removal of the definitions of the terms "labor" and "material" from subsection (c)(9)(B). The State Bar points out that the Third Court of Appeals in three appellate decisions (Newpark, CGG Veritas, and Hegar v. Gulf Copper Mfg. Corp., No. 03-16-00250-CV (Tex. App.- Austin 2017, pet. filed)) have addressed whether a taxable entity furnishing labor to a project for the construction improvement, remodeling, repair, or industrial maintenance of real property is qualified to subtract cost of goods sold by analyzing whether the activities with respect to such labor are an "essential and direct component" of the project. The State Bar argues that this section should follow the Third Court of Appeals' holdings, not adopt the "direct prosecution" test from the Property Code. Furthermore, the State Bar argues that the legislature did not intend for these definitions from the Texas Property Code to apply in the franchise tax context.

Mr. Martens requests revising the definition of "labor" by tracking the definition of the term in subsection (d)(1). He also requests revising the definition of "material" to state "incorporated items, supplies, equipment leased or rented, or repairs, maintenance, improvement, overhaul, and restoration of, or to, equipment leased or rented to be used at particular projects."

The comptroller has determined that the definitions in subsection (c)(9)(B) memorialize the concept that labor and materials must be used in the "direct prosecution of the work" and provide a relevant test for determining when an activity is "too far removed." In response to the State Bar's and Mr. Martens' comments, the comptroller declines to remove or modify the proposed definitions of "labor" and "material." In response to Mr. Martens' first request, the comptroller notes that not all "labor" as defined under subsection (d)(1) qualifies under subsection (c)(9).

The State Bar and Mr. Martens also request the removal of the definition of the term "project" from subsection (c)(9)(B). Both suggest the proposed definition provides a narrow interpretation of Tax Code, §171.1012(i) inconsistent with the language of the statute and court's analysis. Mr. Martens also requests that if the definition of "project" is kept, then the comptroller should provide a broad definition of "project," which encompasses furnishing labor or materials to "one or more existing or potential construction, industrial, or oilfield sites, whether provided at the sites themselves or not." The comptroller agrees to delete the definition of the term "project" in subsection (c)(9)(B)(iii). The comptroller also adds back language that was proposed to be deleted from subsection (c)(9)(B) tracking the third sentence of Tax Code, §171.1012(i).

The comptroller amends subsection (c) to add new paragraph (10) concerning pipeline entities. New paragraph (10) implements House Bill 500, Section 9, which enacted Tax Code, §171.1012(k-2) and (k-3), concerning pipeline entities. The language in paragraph (10) mirrors the statutory language. Subsequent paragraphs are renumbered accordingly.

The comptroller amends renumbered paragraph (11) concerning rentals and leases. To better distinguish this provision from subsection (d)(7) of this section, the phrase "rental or leasing companies" replaces the phrase "rentals and leases."

Additional amendments to paragraph (11) interpret ambiguous statutory language. Tax Code, §171.1012(k-1) provides that motor vehicle rental or leasing companies, heavy construction equipment rental or leasing companies, and railcar rolling stock rental or leasing companies may subtract as costs of goods sold "the costs otherwise allowed by this section in relation to tangible personal property that the entity rents or leases in the ordinary course of business of the entity."

The amendments to renumbered paragraph (11) reflect comptroller policy as affirmed in the Third Court of Appeals in Hegar v. Sunstate Equipment Co., LLC, 2017 WL 279602 at *5 (Tex. App.-Austin Jan. 20, 2017, pet. filed) (mem. op.). The court agreed with the comptroller's interpretation of Tax Code, §171.1012(k-1)(2), "which is that Sunstate may deduct 'all direct costs of acquiring or producing the [heavy construction equipment]' that forms the basis of Sunstate's business, as well as additional costs 'in relation to the taxable entity's [heavy construction equipment].'" The court held, "This reading of the statute is logical and consistent with the apparent purpose of §171.1012(k-1) to extend to renters of heavy equipment the same cost of goods sold deductions available to a company that sells identical equipment." Id.

The amendments provide that certain kinds of motor vehicle rental or leasing companies, a railcar rolling stock rental or leasing company, or a heavy construction equipment rental or leasing company may deduct costs otherwise allowed by Tax Code, §171.1012 in relation to the motor vehicles, railcar rolling stock, or heavy construction equipment that the entity rents or leases in the ordinary course of its rental or leasing business.

The State Bar requests that no substantive changes be made to renumbered subsection (c)(11) in regard to rental and leasing companies. It argues that the proposed language is too restrictive and goes beyond the statute, and additionally, that the comptroller should avoid relying on pending litigation. Mr. Martens requests revising the rule language to allow qualifying rental or leasing companies to subtract as cost of goods sold, the costs otherwise allowed by this section in relation to tangible personal property that the entity rents or leases in the ordinary course of business of the entity. He argues that the proposed language