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IN THE COURT OF APPEALS
THIRD JUDICIAL DISTRICT OF TEXAS
AT AUSTIN

**Glenn Hegar, Comptroller of Public Accounts of the State of Texas; and Ken Paxton, Attorney General of the State of Texas, *Appellants***

**v.**

**Autohaus LP, LLP, *Appellee*.**

FROM THE DISTRICT COURT OF TRAVIS COUNTY, 419TH JUDICIAL DISTRICT
CAUSE NO. D-1-GN-13-000989, HONORABLE DARLENE BYRNE PRESIDING

# BRIEF OF AMICI CURIAE TAXPAYERS

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## STATEMENT OF INTEREST

Five Texas franchise taxpayers representing a cross-section of industries (as detailed below, "the Amici Taxpayers") collectively file this amici curiae brief to apprise the Court of broader tax implications that may arise from its opinion in this case. All Amici Taxpayers share responsibility for the fees incurred to prepare this brief. *See* Tex. R. App. P. 11(c).

The individual Amici Taxpayers' business activities and interests in the subject-matter of this appeal are as follows:

- Gulf Copper & Manufacturing Corporation ("Gulf Copper") is engaged in the business of surveying, manufacturing, upgrading, and repairing offshore drillings rigs. The Comptroller performed a franchise tax audit of Gulf Copper, which included adjustments to the taxpayer's cost of goods sold ("COGS") calculation. Gulf Copper challenged the Comptroller's assessment through a district court protest suit. The 201st Civil District Court ruled in Gulf Copper's favor at trial and the case is now pending before this Court as Cause No. 03-16-00250-CV.

- Southwest Shipyard, LP ("Southwest Shipyard") is engaged in the business of manufacturing, upgrading, and repairing commercial and governmental marine vessels, such as offshore barges, boats, and tugs. The Comptroller performed a franchise tax audit of Southwest Shipyard, which included adjustments to the taxpayer's COGS calculation. Southwest Shipyard challenged the Comptroller's assessment through a district court protest suit, which is pending as Cause No. D-1-GN-15-005538 and is set for trial on January 17, 2017.

- Texas Molecular Limited Partnership ("Texas Molecular) is engaged in the business of chemical manufacturing and environmental disposal of waste generated by both its manufacturing activities and customers operating in the oil and gas, chemical, and galvanizing industries. The Comptroller performed a franchise tax audit of Texas Molecular, which included adjustments to the taxpayer's COGS calculation. Texas Molecular challenged the Comptroller's assessment through a district court protest suit, which is pending as Cause No. D-1-GN-16-000580 and is set for trial on March 6, 2017.

- CGG Services (U.S.), Inc. ("CGG") "is a 'fully-integrated geoseismic' company whose clients are companies that explore for and produce oil and gas. CGG's activities include acquiring seismic data for its clients and processing that data to generate images of the subsurface of the earth that aid in the clients' efforts to produce oil and gas from onshore and offshore locations." *Hegar v. CGG Veritas Servs. (U.S.), Inc.*, No. 03-14-00713-CV, 2016 Tex. App. LEXIS 2439, *4 (Tex. App.—Austin 2016, no pet.). The Comptroller performed a franchise tax audit of CGG for report years 2008 and 2009, which included adjustments to CGG's COGS deduction. CGG challenged the assessment for report year 2008 through a district court protest suit. On appeal, this Court held that CGG was entitled to the COGS deduction claimed for franchise tax report year 2008. CGG's challenge to the audit assessment for report year 2009 is still pending in the Comptroller's administrative hearing process.

- Texas Autocrafters, LP ("Texas Autocrafters") is engaged in the business of selling automobile parts and performing automotive repair. Texas Autocrafters has pending administrative refund claims regarding the COGS.

- Bludworth Marine, LLC ("Bludworth Marine") is engaged in the business of manufacturing and repairing marine vessels. Bludworth Marine has no pending franchise tax audits or litigation.

## STATEMENT REGARDING ORAL ARGUMENT

The Amici Taxpayers agree with the Comptroller and Autohaus that oral argument should be granted in this appeal. The issues are complex, novel, and have statewide importance.

The Amici Taxpayers hope to participate in oral argument, if granted. Thus, after counsel for all parties have had the opportunity to review this Brief, the Amici Taxpayers intend to confer with them and then file a motion for that purpose.

**TO THE HONORABLE THIRD COURT OF APPEALS:**

The Costs of Goods Sold ("COGS") issue presented in this case has broad importance for franchise taxpayers across the State of Texas, including the Amici Taxpayers who have joined together to submit this brief. The Amici Taxpayers, who represent a diverse cross-section of industries, are concerned that the arguments presented thus far are overly-narrow and fail to apprise the Court of the larger context and implications of the COGS deduction at issue. The Amici Taxpayers do not want this Court to inadvertently adopt an interpretation of Texas Tax Code section 171.1012 that could potentially curtail the arguments of other taxpayers.

This brief provides the Court a comprehensive, yet simple application of the COGS statute, which can be used as a framework to resolve the issues in this and future franchise tax cases. The Amici Taxpayers respectfully urge the Court to adopt this analysis in its opinion. Alternatively, the Amici Taxpayers hope that their brief will make the Court aware of the "bigger picture" so the Court can avoid placing unnecessary restrictions on its interpretation of section 171.1012 before other taxpayers have the opportunity to argue their related disputes to this Court.

## SUMMARY OF THE ARGUMENT

Determining whether a taxpayer properly reported its COGS deduction under Texas Tax Code section 171.1012 requires a two-pronged analysis: (1) did the taxpayer qualify for the deduction and, if so, (2) was the deduction properly calculated? This "qualify then calculate" analysis follows the statute's plain language in a manner consistent with the legislative intent. It gives logical meaning to the statute as a whole, acknowledges that our Legislature borrowed heavily from the Internal Revenue Code, and yields a tax calculation that comports with the tax base of margin (or gross profits). It also simplifies reporting and reduces the effort and cost of compliance.

The Comptroller's COGS analysis confuses the distinction between (1) the *types of activities* a taxpayer engages in to *qualify* for the deduction, and (2) the *types of costs* allowed within *calculation* of the deduction. The Comptroller defines "services" too broadly and misinterprets the statute as disallowing the deduction of all service-related costs.

The Comptroller's confusion results from his flawed approach to the statute. First, he ignores the mandate in section 171.1012 that taxpayers use their federal tax accounting methods and applicable deductions as the starting place for their franchise tax COGS deduction. When a taxpayer prepares its federal tax return, it has already performed much of the accounting work needed to lay the foundation for its Texas COGS computation. It would be illogical to require taxpayers to toss aside all of their federal accounting and start anew.

Next, the Comptroller conflates the initial determination of whether a taxpayer qualifies for the COGS deduction with the types of costs allowed for deduction. Compounding this misstep, the Comptroller fails to follow the statutory text. Section 171.1012 provides several categories of allowable costs, exemplified by broad, inclusive lists of the types of costs that fall within each category. In attempt to curtail the costs allowed for deduction, the Comptroller construes the statute's examples as a narrow, exclusive list, and focuses on only isolated costs within that list.

To implement his view of the statute, the Comptroller enacted unnecessary and invalid provisions within his COGS rule. Specifically, Rule 3.588(b)(7) redefined "production" (a type of COGS-qualifying activity) to eliminate "installation" as one of the qualifying acts of production, which is expressly included in the statute. And Rule 3.588(c)(7) invented a label called "mixed transaction," which seeks to implement the Comptroller's across-the-board elimination of service-related costs based on the mistakes discussed above. *See* 34 Tex. Admin. Code § 3.588.

The Comptroller's inverted approach fails to provide a principled calculation method. It creates an administrative nightmare for taxpayers and imposes more tax than is due under the plain language of the COGS statute. This is not what our Legislature intended for Texas businesses. No deference is owed to the Comptroller's erroneous interpretation of this unambiguous statute or to his rule based on that interpretation.

Although the Amici Taxpayers agree with Autohaus's conclusion that it properly claimed the COGS deduction on its 2009 franchise tax report, they believe Autohaus's analysis is, at times, overly-narrow. The Amici Taxpayers address specific areas of disagreement within this brief.

The simple and statutorily-based interpretation of the COGS statute set forth by the Amici Taxpayers can be uniformly applied to resolve the COGS issues related to Autohaus, as well as other taxpayers appearing before this Court. The Amici Taxpayers respectfully urge the Court to adopt their interpretation of section 171.1012 to resolve this case, to establish a consistent framework for taxpayers to follow in calculating their COGS deductions, and as precedent to resolve future COGS disputes.[1]

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[1] The Amici Taxpayers advance no arguments regarding the following issues in Autohaus's case: jurisdiction, declaratory relief, attorney's fees, the constitutionality of the statute as applied to Autohaus, and/or the summary-judgment standards and burdens of proof.

# ARGUMENT

## I. THE COST OF GOODS SOLD DEDUCTION REQUIRES TWO STEPS: QUALIFY THEN CALCULATE.

Proper application of the COGS statute, Texas Tax Code section 171.1012, requires a two-step analysis: (1) qualification of the taxpayer and (2) calculation of the deduction. The first prong focuses on the activities a taxpayer engages in, *i.e.*, the nature of its business. The second prong centers on the costs the taxpayer incurs in performing those activities. If the taxpayer's business activities are of the type our Legislature chose to qualify for the COGS deduction, then the taxpayer is allowed to include all of the costs allowed by the statute in calculating the amount of its COGS deduction. In other words, qualification is a threshold requirement.

Once the taxpayer passes the first prong of the analysis, calculation of its COGS amount simply follows the statutory formula: (1) start with the costs and methods reflected on the taxpayer's federal income tax return; (2) make Texas-specific adjustments, including (a) removal of certain categories of costs that are expressly disallowed under the Texas statute, and (b) limitation of certain costs to a 4% deduction rate; and then (3) sum together those 4%-costs with the remaining categories of costs allowed at a rate of 100% to arrive at the total COGS deduction amount.

### A. Step One: Does the Taxpayer Qualify for the COGS Deduction?

A taxpayer seeking to claim the COGS deduction must first demonstrate that it qualifies under the statute. *See* Tex. Tax Code § 171.1012(i) ("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"); *see also id.* § 171.1012(g) (referring to whether an entity is "allowed" to take a COGS deduction). After the taxpayer crosses the qualification threshold, then it is entitled to calculate the amount of its COGS as directed by other subsections of the statute. *See id.* §§ 171.1012(c)-(f); *infra*, Argument I.B.

Not all taxable entities qualify for the COGS deduction. The most common way to qualify is as an "owner of goods." *See id.* § 171.1012(i). The statute qualifies both *actual* owners (based on the traditional incidents of ownership) and *deemed* owners (who furnish labor or materials to real property construction projects). *Id.* (second sentence, regarding actual owners; and third sentence, regarding deemed owners). In addition to such owners, the COGS statute also provides a handful of industry-specific qualification methods, which are not implicated in Autohaus's case. *See, e.g.*, *id.* § 171.1012(i), (k), (k-1), (k-2), (o), (t).

### 1. *Qualification as an actual owner:*

"The determination of whether a taxable entity is an [actual] owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxable entity." *Id*. § 171.1012(i) (second sentence). There are two ways a taxpayer can become an actual owner of goods: it can produce goods or it can acquire goods from another. Some taxpayers engage in both of these activities, while others engage in only one or the other.

"Goods" means "real or tangible personal property sold in the ordinary course of business of a taxable entity." Tex. Tax Code § 171.1012(a)(1). Thus, an actual owner may qualify for the COGS deduction by selling goods it produced and/or reselling goods it acquired. As relevant here, "tangible personal property" is defined as "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner." Tex. Tax Code § 171.1012(a)(3)(A)(i).

"Tangible personal property" does not include services. Tex. Tax Code § 171.1012(a)(3)(B). This means that a taxpayer whose business activity is purely the sale of services (unrelated to goods) does not qualify for the COGS deduction unless the Legislature has specifically carved out an exception for that service provider. *See, e.g., id.* § 171.1012(k-2) (effective January 1, 2014) (allowing "pipeline entity that provides services to others" to qualify for COGS deduction as specified therein). For example, legal and accounting service providers do not qualify for COGS.

Much of the Comptroller's misinterpretation of the statute originates from the statute's exclusion of "services" from the definition of "goods." As addressed in Argument II.A.2, this exclusion merely limits whether a taxpayer qualifies for the COGS deduction. It does not affect the calculation of the deduction amount once a taxpayer qualifies. If the taxpayer's business activities qualify the taxpayer to claim the COGS deduction, then the taxpayer can include in its calculation all costs allowed by the statute, including service-related costs. *See infra*, Argument I.B.1.b. (regarding IRC section 446); Argument II.A. (regarding allowance of service-related costs).

### 2. *Qualification as a deemed owner:*

The deemed owner provision applies when a taxpayer does not actually own and sell "goods" as defined by subsection (a) but rather "furnish[es] labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance . . . of real property." Tex. Tax Code § 171.1012(i), third sentence. In that instance, the taxpayer is deemed to own the "labor or materials" it furnishes in lieu of owning "goods" that it produces or resells. *Id.*; *see also Combs v. Newpark Res., Inc.*, 422 S.W.3d 46, 55 (Tex. App.—Austin 2013, no pet.) (recognizing that the deemed owner provision would be "meaningless" if the taxpayer had to actually own/sell goods to qualify). Our Legislature has chosen to treat such taxpayers as the equivalent to owners and sellers of goods for purposes of the COGS deduction.

Although the deemed owner provision is not directly relevant to the resolution of Autohaus's case, it is important to understand the overall COGS analysis under section 171.1012, including both actual and deemed owners. Neither the Comptroller nor Autohaus analyze this portion of the statute. The Amici Taxpayers urge the Court to be mindful of it as an alternative method of qualifying for the COGS deduction and to consider the implications of any potential holdings in this case on taxpayers who qualify as deemed rather than actual owners.

### B. Step Two: How Does the Taxpayer Calculate the Cost of Goods Sold Deduction?

Once a taxpayer qualifies for the deduction, the statute instructs the taxpayer on how to calculate it. *See* Tex. Tax Code § 171.1012(i), first sentence (actual and deemed owners "may make a subtraction [of costs allowed] under this section"); third sentence (confirming deemed owners may "include the costs, as allowed by this section, in the computation of [COGS]"). The phrase "this section" means the entirety of section 171.1012.

The Legislature intended for qualifying taxpayers to deduct all of their federal costs after adjusting them as provided by the state statute. As detailed below, to calculate its COGS deduction in accordance with the plain language of the statute, a Texas franchise taxpayer must:

1. start with the accounting methods used and the costs reported on its federal income tax return;

2. adjust those costs in accordance with the Texas COGS statute by:

    a. removing the disallowed costs listed in 171.1012(e); and

    b. limiting the deduction of service-department costs under subsection (f) to a rate of 4% of the total administrative costs; and then

3. add together the costs as adjusted above to arrive at the Texas COGS deduction.

*See id*. § 171.1012(c)-(f), (h).

### 1. *Section 171.1012(h) directs the taxpayer to use the accounting methods and costs from its federal income tax return as a starting place for its Texas COGS calculation.*

Texas Tax Code section 171.1012(h) states the initial step for calculating a Texas franchise taxpayer's COGS deduction:

> <u>A taxable entity shall determine its cost of goods sold</u> except as otherwise provided by this section, <u>in accordance with the methods used on the federal income tax return on which the report under this chapter is based</u>. This subsection does not affect the type or category of cost of goods sold that may be subtracted under this section.

Tex. Tax Code § 171.1012(h) (emphasis added). Subsection (h) is the starting point for the COGS calculation because it begins with the language "[a] taxable entity shall determine," which appears nowhere else in the statute.

Subsection (h) states two requirements. First, a taxpayer must apply the accounting methods used on its federal income tax return to the costs it incurred during the relevant accounting period for the Texas franchise tax report. The most-commonly implicated federal provisions are Internal Revenue Code ("IRC") sections 446 and 263A, discussed below. In applying the accounting methods under these sections, a taxpayer will usually (but not always) identify and deduct the costs reported on the federal income tax return, which corresponds to the underlying franchise tax report.[2] Second, subsection (h) instructs the taxpayer to make the Texas-specific adjustments found in 171.1012. *See* Tex. Tax Code § 171.1012(h), second sentence.

Consistent with subsection (h)'s mandate, other COGS subsections reference specific sections of the Internal Revenue Code (§§ 197, 174, 263A, 460 & 471). *See* Tex. Tax Code §§ 171.1012(c)(6), (c)(9), (g); *see also Appellants' Brief*, pg. 5 (Comptroller acknowledges that section 171.1012(d) was amended in 2013 "to better conform with applicable federal law."). Several other calculations required by the Texas statute also intertwine with a federal counterpart. For instance, franchise tax revenue uses federal gross income as a starting point, and the deduction for compensation and

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[2] Although there is an undeniable correlation between a taxpayer's federal and state COGS calculations, section 171.1012 cannot instruct taxpayers to simply use the deductions directly from their most recent federal income tax return for reasons like the year-end conformity rules applicable to members of a combined group. All members of a combined group must conform their year-end accounting periods to that of the reporting entity. *See* Tex. Tax Code § 171.1014(h). If the reporting entity has a December 31 accounting year-end and a group member has a September 30 accounting year-end, the group member must calculate its COGS using the costs incurred during the twelve months preceding December 31st to confirm to the reporting entity's reporting period. This may create a disconnect between accounting periods used on the Texas franchise tax report and the federal income tax return. For example: Company A and Company B are sibling corporations that join in filing a combined report. Company A is the reporting entity, and its accounting year ends December 31. Company B's accounting year ends September 30. When filing the 2016 Texas franchise tax report, both Companies A and B must use the costs each incurred from January 1 to December 31, 2015. However, Company B's federal income tax return will be based upon its individual accounting period of October 1, 2014 to September 30, 2015.

benefits is based on IRS Forms W-2 and Schedule K-1 (partnership) filings. *See id*. §§ 171.1011, 171.1013(a).

### a. Nearly every other state's tax regime "piggybacks" on federal tax computations.

Using a taxpayer's federal return as the starting place for computation of its state taxes is not a novel or creative legal theory advanced by the Amici Taxpayers. Rather, this practice is commonly known as "piggybacking" or "conformity," and it is employed by nearly every state in this country. "Forty-six states [including Texas] and D.C. impose a tax at the corporate or business entity level that uses net income as at least part of the base." Harley T. Duncan, RELATIONSHIPS BETWEEN FEDERAL AND STATE INCOME TAXES, ¶ 2.2 (Federation of Tax Administrators, April 2005). "This conformity to federal taxable income may be by statutory adoption of the Internal Revenue Code provisions by reference [or] identification of federal taxable income as the state starting point," among others. *Id*. at ¶ 3.3.1. From this, "certain modifications are made . . . to arrive at [a business entity's] state taxable income." *Id*. at ¶ 3.3.2. States rely on federal conformity "primarily as a means to simplify matters for taxpayers and promote compliance with the state income tax. . . . Conformity . . . [means that taxpayers] do not have to deal with two separate sets of tax laws, rules and definitions[,] and do not have to maintain two sets of accounts and books." *Id*. at ¶ 6.2."

Additionally, "[o]f the 41 states (plus the District of Columbia) with broad-based personal income taxes, 40 states and the District of Columbia connect in some way to the federal system by incorporating a range of federal tax expenditures—exclusions, deductions, and credits—into their state tax codes." Anne Staufer and Mark Robyn, *How States Piggyback on Personal Income Tax Calculations*, THE PEW CHARITABLE TRUSTS (April 1, 2016), *available at* *http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/04/01/how-states-piggyback-on-federal-personal-income-tax-calculations*. (providing overview chart); *see also* *How State Corporate Income Taxes Work,* Policy Brief, INSTITUTE ON TAXATION AND ECONOMIC POLICY (Aug. 2011), *available at*: http://www.itep.org/pdf/pb47CIT.pdf (to calculate net income or profits, "most states 'piggyback' on the federal corporate income tax, using the federal definition of taxable income as a starting point.").

b. IRC section 446 generally governs a taxpayer's federal accounting methods.

IRC section 446 provides the general rule for federal accounting methods. *See* 26 U.S.C. § 446. It instructs a taxpayer to select and consistently apply accounting methods that properly reflect the income actually recognized by the taxpayer. *See* 26 U.S.C. § 446(a). IRC section 446 recognizes both high-level accounting methods for use in overall tax calculations (such as cash or accrual basis accounting), and sub-level accounting methods that govern treatment of particular items (such as IRC section 263A, as addressed below). *See, e.g.*, 26 U.S.C. § 446(c); 26 C.F.R. § 1.446-1(a)(1); *see also* 26 C.F.R. § 1.263A-1(j)(3).

(i) *IRC section 446 sets limits on the deductible costs that are incorporated to the COGS calculation.*

To determine which accounting methods apply and how to apply them, IRC section 446 instructs the taxpayer to determine whether it is engaged in a single integrated business or in separate and distinct trades or businesses. If the latter, each separate line of business must elect its own accounting methods. *See* 26 U.S.C. § 446(d). As a result, by the time a taxpayer begins its franchise tax COGS analysis, it has already classified its business activities (and associated costs) as either integrated or separate and distinct—a determination relevant to both the taxpayer's COGS qualification and calculation inquiries.

An integrated business is viewed in its entirety for purposes of its COGS-qualification and deduction of costs, whereas each separate and distinct business requires an independent analysis. The qualification threshold serves to exclude from the deduction costs of non-integrated, pure-service activities. For example, if a taxpayer owns and operates both a furniture manufacturing business and a bookkeeping firm that constitute separate trades or businesses under IRC section 446, the taxpayer will not include the costs associated with its bookkeeping firm in its COGS deduction because the activity does not qualify for COGS. Thus, IRC section 446 serves as a gate-keeper to prevent non-qualifying service providers from claiming the COGS deduction.

The analysis required by IRC section 446 offers a principled and statutorily-based approach to COGS, as contrasted with the Comptroller's disjointed fixation on particular costs and how to parse them in ways inconsistent with guiding federal tax principles and the COGS statute as a whole.

(ii) *IRC section 446 defines what constitutes a separate trade or business.*

IRC section 446 establishes that a taxpayer engaged in multiple business activities may be engaged in an integrated business (with discrete subparts) rather than separate and distinct trades or businesses. "[N]o trade or business will be considered separate and distinct for purposes of

[IRC section 446(d)] unless a complete and separate set of books and records is kept for such trade or business." 26 C.F.R. § 1.446-1(d)(2); *see also Peterson Produce Co. v. U.S.*, 313 F.2d 609, 610 (8th Cir. 1963) (a single general ledger with separate accounts for the various business activities did not point to a separate trade or business). In making this determination, federal authorities also consider factors like:

- would the use of a separate accounting method for each trade or business clearly reflect income?;[3]
- are the activities inherently different?;[4]
- are the activities performed by distinct management, officers, and employees or located in different offices?;[5] and

[3] 26 C.F.R. § 1.446-1(d)(1).

[4] *See Stern v. Comm'r*, 14 B.T.A. 838, 842 (1928) (finding a partnership's retail store activities and its buying and selling of coal lands to constitute separate and distinct trades or businesses because the activities were "wholly different in character"); Rev. Rul. 74-270, 1974-1 C.B. 109 (characterizing commercial banking and trust activities as different because the former is a mercantile business whereas the latter is a personal service business with fiduciary obligations); I.R.S. CCA Mem. 201430013 (noting that the related entities were engaged in different activities—one in manufacturing and the other primarily engaged in sales, marketing, distribution, sales support, research and development, and administrative and headquarters functions).

[5] *See* Rev. Rul. 74-270, 1974-1 C.B. 109 (trust department deemed to constitute a separate and distinct trade or business had its own management, employees, and office space); *Burgess Poultry Market, Inc. v. U.S.*, 1964 U.S. Dist. Ct. LEXIS 9942 (E.D. Tex. May 22, 1964) (division constituting a separate and distinct trade or business had its own location and hired all new operating employees, transferring none from a pre-existing division); I.R.S. CCA Mem. 201430013 (related entities consisting separate and distinct trade or businesses had different geographical locations and did not share employees other than some high-level executives).

- are the operations are integrated and interdependent?[6]

Thus, when complying with federal law (and the Texas Tax Code incorporating it), taxpayers engaged in multiple business activities have already undertaken the analysis of whether the businesses are separate and distinct. Accordingly, when the taxpayer begins its Texas COGS calculation using its federal return as the starting point, the taxpayer has already analyzed its collective business activities and identified those which may be purely services. In fact, this analysis was likely performed years before, at the outset of business operations.

c. IRC section 263A illustrates the common framework for many Texas taxpayers' COGS calculations.

The federal accounting method provided under IRC section 263A applies to taxpayers who produce goods and/or acquire them for resale.

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6 *See Peterson*, 313 F.2d at 611 (upholding trial court finding that departments were too interdependent and well-integrated to be considered separate and distinct trades or businesses); *Burgess Poultry*, 1964 U.S. Dist. Ct. LEXIS 9942 (finding separate and distinct trades or businesses where, among other things, the divisions' transactions were performed at market value and paid by check versus bookkeeping entry and one division was not the majority supplier for the other division); Rev. Rul. 74-270, 1974-1 C.B. 109 (supporting its separate and distinct trades or businesses determination with evidence that regulatory requirements required separate operations of the bank's divisions); I.R.S. CCA Mem. 201430013 (noting that two related entities constituting separate and distinct trades or businesses did not engage in direct transactions with each other; rather, one entity sold to a third party who sold to another third party who, in turn, sold to the related entity).

26 U.S.C. § 263A(b).[7] IRC section 263A is also expressly incorporated into the Texas COGS statute. *See* Tex. Tax Code § 171.1012(g). A side-by-side comparison of Texas Tax Code section 171.1012 and Federal Treasury Regulation 1.263A-1 demonstrates that our Legislature used the latter as the outline from which it drafted the COGS provision, as discussed below. This is likely because IRC section 263A is the federal accounting method most frequently used by Texas taxpayers claiming the COGS deduction, including several of the Amici Taxpayers.[8]

(i) *IRC section 263A is self-policing: It discourages the over-inclusion of costs.*

IRC section 263A's accounting method requires federal taxpayers to capitalize (*i.e.*, delay deduction of) certain costs rather than deduct them in the year incurred. *See* 26 U.S.C. § 263A(a), (b). Congress enacted IRC section 263A to correct deficiencies in the capitalization rules that produced a "mismatching of expenses and the related income and an unwarranted deferral of taxes." *Von-Lusk v. Comm'r*, 104 T.C. 207, 215

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7 This section is commonly pronounced within the tax industry as "263-cap-A."

8 Gulf Copper & Manufacturing Corporation, whose own appeal is presently pending before this Court, will present a trial record detailing the interplay between how IRC section 263A applies to its federal return and its Texas franchise tax COGS calculation. *See* Cause No. 03-16-00250-CV, *Hegar v. Gulf Copper and Manufacturing Corporation* (filed April 14, 2016).

(1995). As a result, IRC section 263A requires a taxpayer to capitalize certain costs incurred for goods that it produces or resells until the taxpayer disposes of the property. *Id.* at 215-16. In other words, the taxpayer cannot deduct the cost at the time it is incurred but instead must wait to deduct the cost upon subsequent disposition of the underlying property.

Because taxpayers prefer to maximize their deductions to minimize the taxes owed, they disfavor IRC section 263A's forced delay in the deduction of costs that would otherwise be immediately deductible. This discourages taxpayers from liberally classifying costs as subject to IRC section 263A. To the contrary, taxpayers are incentivized to capitalize only those costs truly related to the sale or resale of goods within that taxable year.

(ii) *The calculation under IRC section 263A logically informs the Texas COGS calculation.*

In applying IRC section 263A's accounting method, a taxpayer must classify its costs into categories that are strikingly similar to those found in the Texas COGS statute. Based on these substantial similarities, a taxpayer who calculates its federal income tax using IRC section 263A's accounting method has already done the lion's share of work necessary to calculate its COGS deduction under Texas Tax Code section 171.1012. Namely, the taxpayer will have already classified its deductions and segregated service-department costs. This provides the starting place for the Texas COGS calculation.

IRC section 263A divides a taxpayer's costs into three categories: (1) direct costs of production or resale activities, (2) indirect costs that benefit or are incurred by reason of the performance of production or resale activities, and (3) indirect service-department costs. *See* 26 C.F.R. § 1.263A-1(e)(2)-(4); Texas Comptroller STAR Document No. 201307727L at 1-3 (Tax Policy Division to Audit Division Memo dated July 16, 2013) (available at http://aixtcp.cpa.state.tx.us/opendocs/open32/201307727l.html). These three categories of costs track those outlined by Texas Tax Code sections 171.1012(c), (d), and (f). *See infra*, Argument I.B.3.

For example, under IRC section 263A, direct costs of production include the cost of materials that "become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced." 26 C.F.R. § 1.263A-1(e)(2)(i)(A) (*compare with* substantially similar language in Tex. Tax Code § 171.1012(c)(2)-(3)). Similarly, direct labor costs include "the costs of labor that can be identified or associated with particular units or groups of units of specific property produced." *Id.* at § 1.263A-1(e)(2)(i)(B) (*compare with* substantially similar language in Tex. Tax Code § 171.1012(c)(1)); *see also*, 34 Tex. Admin Code § 3.588(e)(1) (expressly referencing the federal regulation).[9]

IRC section 263A, like Texas Tax Code section 171.1012, divides indirect costs into two subsets. *See* 26 C.F.R. § 1.263A-1(e)(3)-(4). The first category consists of indirect costs that "directly benefit or are incurred by reason of the performance of production or resale activities." *Id.* at § 1.263A-1(e)(3)(i)(A). Treasury regulation 1.263A-1 lists several examples of these types of indirect costs, many of which the Texas COGS statute also lists, including: insurance, utilities, spoilage, quality control, and licensing and franchise costs. *Compare* 26 C.F.R. § 1.263A-1(e)(3)(ii)(M), (N), (Q), (S), and (U), *with* Tex. Tax Code § 171.1012(d)(3), (6)-(10). These costs are included 100% in the Texas COGS calculation before the subsection (e) limits are applied. *See* Texas Comptroller STAR Document No.

9 The Amici Taxpayers recognize, however, that the cost categories are not exactly the same. The Texas Legislature adopted a broader definition of direct costs than IRC section 263A by including several costs that would be listed as indirect costs under the federal statute. *Compare, e.g.*, Tex. Tax Code § 171.1012(c)(4)-(7), *with* 26 C.F.R. § 1.263A-1(e)(3)(ii)(G)-(I). But regardless of whether these costs are classified as direct or indirect, they remain deductible as COGS at a rate of 100%.

201307727L (Tax Policy Division to Audit Division Memo dated July 16, 2013).

IRC section 263A's second category of indirect costs is comprised of service (department) costs. 26 C.F.R. § 1.263A-1(e)(4). The statute's companion treasury regulation defines "service costs" as "a type of indirect cost[] that can be identified specifically with a service department or function or that directly benefit[s] or [is] incurred by reason of a service department or function." *Id.* at 1.263A-1(e)(4)(i)(A). "Service departments" are "administrative, service, or support departments that incur service costs," such as "personnel, accounting, data processing, security, legal, and other similar departments." *Id.* at 1.263A-1(e)(4)(i)(B). Businesses often label these as "headquarter" costs.

In 2013, the Comptroller amended the COGS rule to adopt a similar definition of "service costs" for purposes of Texas franchise tax:

> Indirect costs and administrative overhead costs that can be identified specifically with a service department or function, or that directly benefit or are incurred by reason of a service department or function. For purposes of this section, a service department includes personnel . . .; accounting . . .; data processing; security; legal; general financial planning and management; and other similar departments or functions.

34 Tex. Admin Code § 3.588.[10] Four-percent of these costs are included in the Texas COGS calculation. *See* STAR Document No. 201307727L.

Considering the vast similarities between the cost categories in IRC section 263A and the COGS statute, it would be illogical to conclude that our Legislature intended a taxpayer to scrap all of the accounting work it performed for its federal return and start its COGS calculation anew. This is especially true given section 171.1012(h)'s express instruction for taxpayers to use their federal return as a starting place to calculate their COGS amount, and section 171.1012(g)'s express incorporation of IRC section 263A. It is reasonable to conclude that Texas taxpayers who employ IRC section 263A's accounting method on their federal return should use the costs included in that calculation as a starting place for the costs

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[10] The Comptroller incorrectly asserts that the prior rule language applies to Autohaus. *See Appellants' Brief*, pg. 5-6. To the contrary, the 2013 rule amendments apply retroactively to franchise tax reports from 2008 onward. *Compare* 34 Tex. Admin. Code § 3.588(a) ("Effective date. The provisions of this section apply to franchise tax reports originally due on or after January 1, 2008") *with* 34 Tex. Admin. Code § 3.589(a) ("Effective date. The provisions of this section apply to franchise tax reports originally due on or after January 1, 2008, except as otherwise noted.") *and* 34 Tex. Admin. Code § 3.599(a)(1) ("Effective dates. The provisions of this section apply to franchise tax reports originally due on or after January 1, 2014"); *see also, e.g.*, Texas Comptroller STAR Document No. 201409972H (Hearing Nos. 108,959 and 108,960 dated Sept. 26, 2014) (applying the 2013 revisions to Rule 3.588 retroactively for franchise tax report years 2008 and 2009). Thus, Autohaus's appeal is governed by the amended language of the rule.

allowed in its COGS deduction. And, due to the self-policing nature of IRC section 263A, this does not provide a "windfall" to Texas taxpayers.[11]

### 2. *Next, the taxpayer makes Texas-specific adjustments.*

A taxpayer must then adjust its federal costs as specified by the Texas statute to arrive at its COGS deduction. *See* Tex. Tax Code § 171.1012(h) (stating that the incorporation of federal accounting methods "does not affect the type or category of cost of goods sold that may be subtracted" for COGS).

#### a. Remove Texas disallowed costs.

A taxpayer may not include in its Texas COGS deduction the statutorily-prohibited costs in subsection (e), even if those costs are deducted on its federal return. Unlike subsections (c), (d), and (f), subsection (e) is written in exclusive terms: this is an exhaustive list of the only costs that are disallowed. *See* Tex. Tax Code § 171.1012(e) (listing, *inter alia*, costs for officers' compensation, advertising, and selling). A

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11 Although most Texas taxpayers applying the COGS deduction will have used IRC section 263A's accounting method to calculate their federal income tax, this is not a requirement for the Texas taxpayer to qualify for COGS. If the taxpayer has not used IRC section 263A, it simply does not have the benefit of having already categorized its allowable costs. In that instance, the taxpayer begins its calculation by identifying the direct and indirect costs it has incurred of the types allowed for deduction under subsections (c), (d), and (f); removes any costs contained on the exclusive list of disallowed costs under subsection (e); and limits certain costs to 4% as required by subsection (f).

taxpayer must remove all costs listed in section 171.1012(e) from its federally-deducted costs in calculating its Texas COGS amount. *Compare, e.g., id., with* 26 C.F.R. § 1.263A-1(e)(3)(ii)(B) and (iii)(A) (identifying these Texas disallowed costs as indirect, allowed costs for purposes of IRC section 263A).

b. Limit service-department costs to 4%.

For the "service-department" costs categorized under subsection (f), the taxpayer must first calculate its total amount of administrative and indirect costs. As a Texas-specific adjustment, the taxpayer must then limit its service-department costs to 4% of that total. Tex. Tax Code § 171.1012(f). This represents the amount of service-department costs allowed for deduction, as reported on line 12 of the franchise tax report. *See* Texas Franchise Tax Report, Form 05-158 (Report year 2009); *see also* Texas Comptroller STAR Document No. 201307727L at 2 (noting that the 4% cap on service-department costs "is a departure from the federal approach which includes the indirect and administrative costs directly allocable to production or acquisition as a capitalizable cost recoverable as goods are sold, WITHOUT LIMITATION.") (emphasis in original).

### 3. *The resulting sum of 100% and 4% costs is the Texas COGS deduction amount.*

Our Legislature enacted subsections 171.1012(c), (d), and (f) to provide broad, inclusive (not exhaustive) lists of the common types of costs allowed for deduction by qualifying taxpayers. *See, e.g.*, Tex. Gov't Code § 311.005(13) (Use of word "includes" is term of enlargement and "not of limitation or exclusive enumeration"); *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, 2015 Tex. App. LEXIS 4388, *20 (Tex. App.—Austin 2015, no pet. h.) (motion for rehearing pending) (construing the term "production" broadly to include numerous activities listed under section 171.1012(a)(2) because the term "include" is a term of enlargement.

With the Texas disallowed costs (subsection (e) costs) removed and the service-department costs (subsection (f) costs) properly limited to 4%, the taxpayer looks to the remaining costs included in its federal calculation. These remaining costs comprise the direct and indirect costs allowed for deduction at a rate of 100%, as broadly described by the categories in subsections (c) and (d). The total of these 100% costs is reported on line 11 of the franchise tax report. *See* Texas Franchise Tax Report, Form 05-158 (Report year 2009).

The taxpayer then sums together line 11 (100% costs) and line 12 (4% costs) to result in the "Total Costs of Goods Sold," as reported on line 14.

*Id.* The total COGS amount is then subtracted from the total revenue amount to arrive at the COGS-based margin (line 20). *Id.*

## II. THE COMPTROLLER'S COGS ANALYSIS IS FLAWED.

In an effort to curtail the costs allowed for deduction under section 171.1012, the Comptroller (1) defines "service" too broadly, (2) misapplies the term "service" by using it to limit a taxpayer's allowable *costs* rather than to identify non-qualifying *activities*, and (3) ignores other costs expressly allowed for deduction.

The Comptroller's flawed analysis results from his failure to follow the principled approach set forth by the statute's plain text. Section 171.1012 employs a "top down" analysis that begins with a comprehensive review of the taxpayer's business activities, already classified into separate trades or businesses as required by IRC section 446. If any given business line qualifies for the COGS deduction, then the taxpayer calculates the amount of its deduction, starting with the costs reported on its federal return for that business. The relevant costs have already been separated under IRC section 446 and, in most cases, further segregated into COGS-relevant classes. After the taxpayer makes Texas-specific adjustments, its remaining costs are essentially carried over from the federal return to its

COGS deduction at the statutorily-allowed rate (100% or 4%) without the need for further parsing or limitation.

The Comptroller inverts the analytical framework intended by our Legislature. Rather than starting with taxpayer qualification and federal piggybacking, the Comptroller employs a "bottom up" approach that begins by contrasting the taxpayer's costs against the statutory examples in (c), (d), and (f). More precisely, the Comptroller parses a taxpayer's vendor invoices, one by one into non-qualifying, service-related, and qualifying costs. If the Comptroller believes the costs are related to a service (under his broad definition), he simply disallows them. This interpretation fails to follow the statute's text and underlying purpose.

If the Court follows the principled, "top down" approach mandated by the statute, it inherently resolves the problems perceived by the Comptroller. Under the proper analysis, the limitation on services is confined to a taxpayer's qualifying activity, and initial limitations on a taxpayer's allowable costs have already been applied under the federal accounting methods. Thus, there is no need to further parse and limit "service related" costs incurred by a qualifying taxpayer for purposes of the COGS deduction.

Nevertheless, the Amici Taxpayers specifically respond to the Comptroller's arguments about the meaning of "service," how that term impacts the COGS calculation, and what specific costs are allowed or disallowed under the statute.

## A. The Comptroller Overstates the Meaning and Implications of "Service."

The Comptroller broadly labels many costs as being related to "services" and then disallows their deduction based on the argument that "section 171.1012 prohibit[s] the inclusion of services as part of a [COGS] deduction." *See, e.g., Appellants' Brief*, pg. 28. The Comptroller casts too wide a net over the meaning of "services" and he ignores the important distinction between a taxpayer's qualifying *activities* (step 1) and, if that threshold is satisfied, the *costs* allowed for deduction (step 2).

### 1. *The Comptroller's definition of "service" is too broad and not properly distinguished from "labor."*

According to the Comptroller, the term "service" in section 171.1012 should be interpreted to include every activity that provides any benefit to anyone. *See Appellants' Brief*, pg. 29. Although this definition might be appropriate for other statutes, it is too broad for purposes of the Texas Franchise Tax Code.

The Comptroller relies on a water contract case brought under Local Government Code section 271.152 to support its broad definition of "services." *See Appellants' Brief*, pg. 29 and *Reply Brief*, pg. 4 (citing *Kirby Lake Dev., Ltd. v. Clear Lake City Water Auth.*, 320 S.W.3d 829 (Tex. 2010)). There, the question was whether the City contracted to provide "goods or services" within the scope of the sovereign-immunity waiver in section 271.152. Because the statute expressly referred to "goods or services," there was no need to draw a meaningful distinction between these terms to resolve the dispute, and the Court could broadly interpret services to include "any act performed for the benefit of another." *Kirby Lake*, 320 S.W.3d at 839.

*Kirby Lake* does not provide a helpful analysis to decide the meaning of "services" under section 171.1012. For franchise tax purposes, it is not only necessary to treat "goods" and "services" separately but also to draw a finer distinction between "service" and "labor" activities. In this context, a narrower definition of "services" is required.[12]

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[12] Just as *Kirby Lake's* holding about the meaning of services under the Local Government Code is not relevant here, neither are holdings construing that term for purposes of other statutes. The supreme court recently issued its opinion in *Centerpoint Builders GP, LLC v. Trussway, Ltd.*, No. 14-0650, 2016 Tex. LEXIS 505 (Tex. June 17, 2016). At first blush, portions of this opinion may appear relevant to the determination of whether Autohaus is entitled to a COGS deduction. But upon further review, *Centerpoint* is plainly limited to deciding, under Texas Civil Practice and Remedies Code chapter 82, whether a general contractor qualified as (1) a "seller" of defective

As this Court previously recognized, "service" and "labor" have distinct (but not mutually exclusive) meanings under section 171.1012. *Combs v. Newpark Res., Inc.*, 422 S.W.3d 46, 54-55 (Tex. App.—Austin 2013, no pet.); *see also Hegar v. CGG Veritas Servs. (U.S.), Inc.*, No. 03-14-00713-CV, 2016 Tex. App. LEXIS 2439, *10 (Tex. App.—Austin 2016, no pet.). As used in this statute, it is illogical to define "service" as "any beneficial activity" because that would wholly encompass labor, the

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trusses and was therefore entitled to indemnity from the truss manufacturer or (2) a service provider who was not entitled to indemnity. *Id.* at *2.

The opinion is expressly based on and limited to an interpretation of the language in CPRC chapter 82 and contains no discussion of concepts relevant to *Autohaus* or the Texas Tax Code. *See, e.g., id.* at *24-25. For example, *Centerpoint* fails to discuss any distinction between service versus labor, a concept relevant for COGS qualification. If a general contractor were automatically labeled a service provider under *Centerpoint*, he would not be eligible for the COGS deduction as a deemed owner furnishing labor or materials to real property construction projects. This leads to an absurd result because this COGS provision was primarily enacted to allay the fears of the construction industry about its members' ability to claim the deduction. *See* Tex. Tax Code § 171.1012(i), third sentence; *Newpark*, 422 S.W.3d 46, 55 (Tex. App.—Austin 2013, no pet.) ("[T]he legislature could have reasonably intended section 171.1012(i) to allow [] companies [like contractors and subcontractors who furnish labor or materials to real-property improvement projects] to deduct their costs as if they were a cost of goods sold. Otherwise, section 171.1012(i)'s provision making the party that furnishes labor the 'owner' of that labor would be meaningless.") (internal citations omitted).

Also, application of *CenterPoint's* service-provider-not seller holding would have ramifications with respect to Texas sales tax because contractors operating under separated contracts (*i.e.*, a contract that separately states the labor charge from the materials charge) are treated as the retailer of materials that are physically incorporated into real property and are entitled to purchase those materials tax-free under the resale exemption. *See* 34 Tex. Admin. Code § 3.291(b)(4)(A)-(B).

For these reasons, *Centerpoint* is inapplicable to disposition of the issues in Autohaus's case.

performance of which likewise provides a benefit to the taxpayer's customer.[13]

Under the Comptroller's overly-broad definition of "service," a contractor installing a new roof on an office building (*i.e.*, "furnishing labor or materials" as contemplated in section 171.1012(i)) would not qualify for the COGS deduction because the activity provides a benefit to the taxpayer's customer. Likewise, the Comptroller's definition would include an auto manufacturer (like Chevrolet) as a "service" provider because its customers benefit from the cars manufactured. These examples demonstrate that (1) the Comptroller's interpretation is directly contrary to the statute's plain language, under which both of these taxpayers would qualify for COGS; and (2) the Comptroller's interpretation would lead to absurd results because every activity related to the sale or resale of goods would be defined as a service because it is "beneficial" in some manner. This Court should reject the Comptroller's definition of "service" for purposes of the franchise tax.[14]

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13 Notably, the Comptroller does not cite *Newpark* or *CGG* a single time in his opening or reply briefs, despite these being the most on-point authorities governing the interpretation of "services" in this case.

14 In pushing his broad interpretation of "services," the Comptroller incorrectly argues that "the labor incurred to install a good into a customer's vehicle . . . [s]quarely falls <u>within the statutory definition</u> of 'services.'" *Appellants' Brief*, pg. 4 (emphasis added). However, no statutory definition of services exists, which is precisely why this

Instead, the Court should use the definition stated in *Newpark*: "[B]oth labor and services are generally work done for another, with labor potentially including an additional expenditure of either physical or mental effort." *Id.* at 54 n.8. *Newpark* recognized the potential distinction that *service* is a form of "labor that does not produce a tangible commodity," meaning *labor* would be an activity that is related to the production or resale of a commodity (*i.e.*, a good). For example, accountants engage in beneficial work for others that requires mental effort but does not have a sufficient connection to the production of a good. This is a typical "service" activity. Auto mechanics, on the other hand, engage in beneficial work for others that requires mental and physical effort and does have a sufficient connection to the production or resale of a good. This is a typical "labor" activity.

Although the meanings of "service" and "labor" do "substantially overlap" and are often "interchangeable" (*Newpark*, 422 S.W.3d at 54), it is sometimes necessary to distinguish them for franchise tax purposes. In those instances, the connection (or lack thereof) between the activity

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Court should follow its prior holdings about the meaning of that term for franchise tax purposes.

performed and the ultimate production or resale of a good provides a helpful framework in which to analyze the issue.

The distinction between service and labor based on the level of connection between the activity and the good is consistent with the Comptroller's own publications. *See* 34 Tex. Admin. Code § 3.588(b)(9) (describing service providers as accountants and lawyers); Texas Comptroller STAR Document No. 201606856L (Tax Policy Memo dated June 13, 2016) (same). This distinction is also consistent with federal tax regulations interpreting IRC section 263A, which as addressed above, informs the COGS calculation. *See* 26 C.F.R. § 1.263A-1(b)(11).[15]

As with most legal questions, there will be grey areas. Whether or not a sufficient connection exists between any given activity and any resulting good will have to be decided on a case-by-case basis.[16] But adopting this standard would provide a consistent test to apply in all franchise tax cases.

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15 Autohaus also urges this Court to follow *Newpark* for the meanings of "service" and "labor," and correctly notes that the Legislature did not intend to characterize all labor as services. *Appellee's Brief*, pgs. 23-25. However, Autohaus does not highlight the important distinction based on the connection between the activity and the good produced. Autohaus also does not clarify that whether a taxpayer provides a service is relevant only for determining if the taxpayer engages in a qualifying business activity (selling/reselling goods), and not for calculating a taxpayer's deductible costs. The Amici Taxpayers believe both points are important to correctly interpret section 171.1012.

16 That is, unless the Court adopts the principled approach, piggybacking on the federal accounting methods and costs, which would resolve the "service" related problems perceived by the Comptroller.

The Amici Taxpayers contend that this would benefit the State in attracting businesses and developing a strong economy, benefit the judicial system in developing consistent precedent, and benefit taxpayers by providing clear guidance on COGS issues for fair and uniform calculation tax base.

### 2. *Selling services affects only taxpayer qualification not calculation of the deduction amount.*

The Comptroller's analysis disregards the important distinction between the (1) business *activities* that qualify a taxpayer to take a COGS deduction, versus (2) deductible *costs* incurred by the taxpayer in performing such activities. *See, e.g., Appellants' Brief*, pg. 30 (illogically arguing that "installation labor costs are only included as [COGS] when they are not performed as a service") (emphasis added). The limitation on "services" in section 171.1012 affects only the (1) qualification threshold, not (2) the calculation of the deduction.

Section 171.1012(a)(3)(B)(ii) states that "tangible personal property" (a type of "goods") does not include "services." Hence, taxpayers who provide only services (such as accountants and lawyers) do not qualify for the COGS deduction because they are not engaged in the correct type of business activity. Their activities are not sufficiently connected to a resulting good. On the other hand, taxpayers who sell/resell goods or furnish labor/materials to real-property construction projects qualify for the COGS deduction because they are engaged in the business activities covered by section 171.1012(i). If those qualifying taxpayers incur service-related costs as part of their business activities, then the statute allows them to deduct those costs as COGS.

This Court should reject the Comptroller's efforts to transform the simple limitation against service-only providers qualifying for COGS into an extra-statutory restriction on the types of costs allowed for deduction as COGS.[17] As evidenced by the statute's examples of service-related costs and as argued below, our Legislature did not intend to prohibit the deduction of service-related costs.

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[17] It is an interesting exercise to review the Comptroller's Brief and replace the word "labor" wherever the Comptroller says "service." In nearly every instance, this change in semantics demonstrates an opposite conclusion from that drawn by the Comptroller. For example, the Comptroller argues that Autohaus cannot deduct the costs of installing parts onto a vehicle because these costs are incurred while a "mechanic [performs] the <u>service</u> of repairing" an automobile. *Appellants' Brief*, pgs. 15-16 (emphasis added). But the work the mechanic is doing is more properly characterized as "labor." If the word "labor" is substituted for "service" in the sentence quoted above, the result is that the costs fall directly within section 171.1012(c). This Court should not be led astray by the Comptroller's creative wordsmithing. Just because the Comptroller broadly labels something as "service" and claims it fails the COGS standard on that basis does not make it so.

### 3. ***The statute expressly allows taxpayers to deduct service-related costs.***

A taxpayer who qualifies as an actual or deemed owner of goods is entitled to subtract all of its allowed costs, including costs arising from the performance of a service, as the statute expressly provides. *See* Tex. Tax Code § 171.1012(c), (d), (f); *see also Hegar v. CGG Veritas Servs. (U.S.), Inc.*, No. 03-14-00713-CV, 2016 Tex. App. LEXIS 2439, *10 (Tex. App.—Austin 2016, no pet.) ("[W]e concluded [in *Newpark*, 422 S.W.3d at 56] that the legislature intended section 171.1012 to permit taxable entities to deduct a wide range of labor expenses, including those associated with activities that might also be described as a 'service.'").

Here, the inquiry is not about the types of activities the taxpayer engages in to qualify. Rather, the focus is on the types of costs a qualifying taxpayer may incur as part of those activities. For example, if a qualifying taxpayer is required to pay for the provision of utility or electric services used in the taxpayer's production of goods, then those service costs are deductible at a rate of 100% as evidenced by subsection (d)(8). Other provisions likewise illustrate the deductibility of service-related costs at a rate of 100%. *See, e.g.*, Tex. Tax Code § 171.1012(c)(4) (handling costs); *id.* at § 171.1012(c)(9) (research costs); *id.* at § 171.1012(d)(7)-(9) (assorted quality control costs). Additionally, qualifying taxpayers may deduct 4% of their service-department or "headquarter" costs, such as accounting, legal, and personnel ("HR") costs. *Id.* at § 171.1012(f).

Nothing in the statute categorically disallows all service costs as argued by the Comptroller. The only disallowed costs are listed in subsection (e)—a provision that the Comptroller ignores. Under the proper analysis, if a qualifying taxpayer incurs a service-related or a service-department cost, then it is deductible unless disallowed under subsection (e).

The Amici Taxpayers also respectfully disagree with Autohaus's analysis of this issue. Autohaus mistakenly contends that "service costs" are not deductible. *See Appellee's Brief*, p. 24-25, n.3. The flaw in Autohaus's reasoning is demonstrated by its citation to only subsection (c), which overlooks the statutory formula beginning with subsection (h), the adjustments under subsections (e) and (f), and the additional costs allowed for deduction in subsection (d).

### B. The Statute Does Not Limit Deductible Costs to Direct Costs.

The Comptroller argues that taxpayers are allowed to deduct only their "direct" costs as COGS. *See Appellants' Brief*, pgs. xi, 17 (citing section 171.1012(c)); *Appellants' Reply Brief*, pg. 8. This argument should be rejected because it would render meaningless other portions of the statute.[18]

First, the Comptroller's over-emphasis of subsection (c) renders subsection (e) superfluous. If the Legislature had intended for taxpayers to deduct only the direct costs listed in subsection (c), it would not have needed to enact subsection (e), which identifies costs not listed in subsection (c) and prohibits taxpayers from including them in the COGS deduction. *See, e.g.*, Tex. Tax. Code § 171.1012(e)(9) (listing "interest" as a disallowed cost).

Second, taxpayers are also allowed to deduct "indirect" costs, as shown by the examples in subsections (d) and (f). *See supra*, Argument I.B.1. These subsections, like subsection (c), provide descriptive (not exhaustive) lists of the types of costs allowed for deduction as COGS. They are all written as "including," but not being limited to, the types of costs stated.

Subsection (d) does not impose a global requirement that the costs be "direct." Certain costs listed in subsection (d) are direct, while others are

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18 The distinction between direct and indirect costs is illusive. For example, subsection (c)(8) defines the cost of repairs and maintenance of production equipment to constitute a direct cost of production, even though these costs are clearly an indirect cost because the repairs and maintenance do not have an immediate effect on the product. Moreover, the Comptroller's own rule juxtaposes the concepts by defining "direct labor" to include "indirect labor costs." *See* 34 Tex. Admin. Code § 3.588(d)(1).

not. *Compare* Tex. Tax Code § 171.1012(d)(8) ("cost of utilities . . . directly used in the production of goods"), *with id.* at § 171.1012(d)(3) ("spoilage and abandonment [costs], including the costs of rework labor, reclamation, and scrap"). In the absence of an express requirement to the contrary, the Legislature intended subsection (d) to provide examples of both direct and indirect costs allowed for deduction at a rate of 100%.

Subsection (f) expressly includes certain "indirect" costs in the COGS calculation. *Id.* at § 171.1012(f) ("A taxable entity may subtract as a cost of goods sold indirect or administrative overhead costs, including . . . "). The difference between the types of costs covered by subsection (f) is that they may be deducted at a rate of only 4% of the total administrative costs rather than the 100% deduction rate applicable to the types of costs covered by subsections (c) and (d). *Id.*

The Comptroller's argument that only direct costs may be deducted is yet another attempt to limit the COGS calculation beyond what our Legislature intended. It is important to recognize that the Comptroller consistently narrows the statutory text to disallow deductions of costs that are expressly allowed. This Court should follow the statute's plain language without the improper limitations urged by the Comptroller.[19]

## III. PORTIONS OF THE COMPTROLLER'S COGS RULE ARE INVALID.

To enforce his misinterpretations of section 171.1012, the Comptroller enacted a COGS rule aimed at parsing a taxpayer's business activities and disallowing the deduction of certain costs expressly covered by the statute. *See* 34 Tex. Admin. Code § 3.588(b)(7), (c)(7). "The Comptroller cannot through rulemaking impose taxes that are not due under the Tax Code." *Combs v. Roark Amusement & Vending, L.P.*, 422 S.W.3d 632, 638 (Tex. 2013). As such, the Court should conclude these portions of the rule are invalid and not defer to them for the following reasons.

### A. Definition of Production, Rule 3.588(b)(7).

Section 171.1012(a)(2) defines "<u>production</u>" to include, <u>without limitation</u>: "construction, <u>installation</u>, manufacture, development, mining,

[19] Autohaus also mistakenly claims that "the cost of goods sold deduction is limited to the costs of acquiring or producing goods that are sold," and appears to overlook a taxpayer's ability to also deduct indirect costs. *See, e.g.*, *Appellee's Brief*, pgs. vii, 6, 10, 24 n.3 (citing Tex. Tax Code § 171.1012(c)). The Amici Taxpayers disagree with these statements. First, they ignore subsections (d) and (f). Second, they place undue restrictions on the plain text of subsection (c), which broadly allows for deduction of all direct costs that are incurred by the taxpayer as part of its acquisition or production of goods and lists several categories of the types of costs that would fall within this description.

extraction, improvement, creation, raising, or growth." Tex. Tax. Code § 171.1012(a)(2) (emphasis added).

The Comptroller contends that the statute does not mean what it plainly says. Instead, the Comptroller redefines "production" to include "installation" only if it "occur[s] during the manufacturing or construction process." 34 Tex. Admin. Code § 3.588(b)(7).[20] The Comptroller arbitrarily considers any other form of installation to be a "service," and on this basis, disallows all costs incurred in performing the activity.

Each of the Comptroller's arguments in support of Rule 3.588(b)(7) lacks merit. This Court should affirm the district court's ruling that the rule is invalid.

### 1. *The rule conflicts with statute's plain language.*

The Amici Taxpayers agree with Autohaus that the Comptroller's definition of installation adds words into the statute that our Legislature did not intend, and renders meaningless terms that were expressly included. *See Appellee's Brief*, pgs.13-19; *Appellee's Reply Brief*, pgs. 2-6. As briefed by Autohaus, nothing in the plain language of section 171.1012 restricts the meaning of "installation" as advanced by the Comptroller.

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[20] This definition relates only to taxpayers who qualify as actual owners and does not implicate those who qualify as deemed owners by furnishing labor and materials to real-property construction projects.

### 2. *Use of the term "or" in section 171.1012(c) does not limit Autohaus's deduction to only acquisition costs.*

According to the Comptroller: Autohaus's installation of auto parts cannot be considered "production" because Autohaus "acquired" the parts from another manufacturer, and the statute allows deduction of only its costs to acquire "or" produce the parts but not both. *See Appellants' Brief*, pg. 20-21 (citing Tex. Tax Code § 171.1012(c)). In other words, the Comptroller claims that Autohaus cannot be both an acquirer and a producer of goods. This argument should be rejected because it leads to absurd results and ignores the economic reality of many taxpayers' business models.

If the statute were written as allowing deduction of the costs incurred to "acquire **and** produce" goods, then it would require **all** taxpayers to engage in **both** activities before they could qualify for the COGS deduction. Although many taxpayers (like Autohaus) both acquire and produce goods, many others do not. If the statute required both, it would unnecessarily disqualify all of those taxpayers who engage in only one or the other activity.

The logical interpretation is that taxpayers can qualify as actual owners of goods by acquiring and reselling goods, or producing and selling goods, or by doing both of these things. If they do both, then they can deduct all of the costs incurred as part of both activities. If a taxpayer engaged in both activities but its deduction was unnecessarily limited to costs of only one or the other, then it would not result in a tax on margin as intended by the Legislature.

The absurdity of the Comptroller's interpretation of the word "or" is further demonstrated by the language in subsection (i). Under the third sentence, a taxpayer can qualify as a deemed owner by furnishing labor "or" materials to a real-property construction project. The Comptroller has never argued (and it would be wholly illogical to argue) that a taxpayer who furnishes labor "and" materials cannot qualify because the statute requires that the taxpayer do only one "or" the other. Just as the term "or" in subsection (i) means "and/or," so does that term in subsection (c).

Furthermore, the Comptroller has already determined that resellers may deduct production-related costs. *See* Texas Comptroller STAR Document No. 201504069L (Tax Policy Division to Audit Division Memo dated April 23, 2015) (stating the Comptroller's policy of allowing a taxpayer to deduct research and development costs, even though the taxpayer "is not the producer of the goods it sells.").

### 3. *The statute does not require Autohaus to own the vehicle to which its parts are installed.*

The Comptroller contends that a taxpayer's installation of materials must be "onto or into the personal property that the business owns and is actually producing for sale." *See Appellants' Brief*, pg. 2; *see also id*. pgs. 22-23; *Appellants' Reply Brief*, pgs. 5-6. According to the Comptroller, if the customer owns the property, then the taxpayer's "installation labor" constitutes a "service." *See id.*, pg. 22. But, if the taxpayer owns the property, then its installation constitutes an act of production. *See id.* The Comptroller premises this distinction on his view that production occurs only when labor is applied to unfinished materials to generate a product held for sale— *i.e.*, manufacturing or construction.

As previously briefed, the statute does not define production so narrowly. "Installation" must be given a meaning separate and distinct from the other listed production activities and cannot be confined to acts of manufacturing and construction. The Comptroller's argument fails because it renders meaningless the other words expressly included by our Legislature.

Nothing in section 171.1012 requires that a taxpayer own the property into which the taxpayer's goods are installed. Our Legislature required only that a taxpayer own goods (auto parts) that it produces (installs) for sale to another (the customer). *See* Tex. Tax Code § 171.1012(i). If the taxpayer engages in this business activity, then it qualifies for the COGS deduction and may include all of the statutorily-allowed costs in its calculation.

The Comptroller implies that it would be unfair to allow both the auto-part manufacturer and the mechanic/installer who does not own the vehicle to deduct costs associated with the sale of the good. *Appellants' Reply Brief*, pgs. 5-6. Yet the Comptroller concedes that both of these taxpayers would be permitted to deduct their costs if the mechanic owns the vehicle. *Id*. This demonstrates the fallacy in the Comptroller's reasoning. If his concern is two taxpayers deducting costs associated with the same good, then why should it make any difference whether the mechanic owns the vehicle or not? In the latter scenario, in which the Comptroller agrees the mechanic is allowed to take the deduction, there are still two taxpayers deducting costs related to the same good. There is no logical reason for treating the mechanic differently in these two scenarios. Nothing in the statute bases the taxpayer's qualification for the COGS deduction on ownership of the ultimate product.[21]

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[21] In any event, both taxpayers in this scenario would not be deducting the same costs. For example, if General Motors (GM) manufactures an alternator at a cost of $100 and sells it to a part shop for $200, then GM generates a $100 margin on its sale. If the part shop then resells the part for $350, it generates a margin of $150. Each taxpayer is taxed on its margin, which is calculated by deducting the taxpayer's COGS from its revenue. The cumulative revenue of $550 less the cumulative COGS of $300

#### 4. *The costs described by subsection (c)(2) do not limit Autohaus's deduction of other costs.*

Subsection (c)(2) allows for deduction of "the cost of materials that are an integral part of the specific property produced." The Comptroller uses circular reasoning to argue that this provision limits Autohaus's deduction. His argument is difficult to follow, especially given that the deduction of labor costs—not material costs—is in dispute in Autohaus's case. Nevertheless, the Comptroller's point appears to be that a taxpayer must be engaged in manufacturing or construction to deduct costs under (c)(2) because those are the only activities the Comptroller believes qualify as "production." This argument fails for the same reason as the Comptroller's invalid definition of "production."

Moreover, the statute does not limit the deduction of material costs to only those that are an "integral part" of the produced property. Subsection (c) is globally written in inclusive terms. The very next example of a deductible cost category ("cost of materials that are consumed in the ordinary course of business") demonstrates that a qualifying taxpayer's deduction of material costs is not limited to those stated in (c)(2).

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equals the cumulative margin of $250. Thus, there is no "double counting" of costs. The Comptroller's implication otherwise is a red herring.

### B. Mixed Transactions, Rule 3.588(c)(7).

The Comptroller's mixed-transaction provision states: "If a transaction contains elements of both a sale of tangible personal property and a service, a taxable entity may only subtract as cost of goods sold the costs otherwise allowed by this section in relation to the tangible personal property sold." 34 Tex. Admin. Code § 3.588(c)(7). By limiting the costs allowed for deduction to those "in relation to the tangible personal property sold," the Comptroller erroneously claims that all costs he deems to be "service costs" are disallowed.

As an initial matter, the district court did not declare the mixed transaction provision to be invalid, and it does not apply to Autohaus because the work it performs to install auto parts is "labor," not a "service." *See supra*, Argument II.A.1. Thus, even if the mixed-transaction rule were valid, it would not prohibit deduction of Autohaus's labor costs. [22]

The Amici Taxpayers nevertheless address this provision because its origins are intertwined with the Comptroller's limited definition of

[22] The mixed transaction provision also appears to be wholly inapplicable to taxpayers who qualify for COGS as deemed owners. The provision applies only to transactions involving both the "sale of tangible personal property" and provision of "a service." Deemed owners qualify based on furnishing labor and materials, not selling tangible personal property. Thus, even if some component of service is involved in a deemed owner's activities, the rule does not appear to disallow the taxpayer's service-related costs from subtraction as COGS. Instead, a deemed owner's COGS calculation simply remains governed by the statute, as set forth above in Argument I.A.2.

production, and because the Comptroller relies on it as support for his misinterpretation of section 171.1012. *See, e.g., Appellants' Brief*, pg. 5. This Court should reject the Comptroller's faulty and circular reasoning.

The term "mixed transaction" appears nowhere within the text of section 171.1012. The Comptroller invented this term to create a limitation where our Legislature did not intend one to exist.

The Comptroller argues that if a taxpayer installs a good that it owns as a component part of property owned by the customer, then the taxpayer's "installation labor" is a "service," and "is not deductible as a cost of goods sold." *Appellants' Brief*, pg. 19. This is wrong, for the same reasons addressed above. The plain text of the statute demonstrates that the costs should be included in the taxpayer's COGS calculation because (1) the taxpayer qualifies for the deduction as an actual owner of goods, and (2) the costs fall within the allowed categories under subsections (c), (d) and (f), as carried over and adjusted from the taxpayer's federal tax return. Confusion arises only under the improper semantics employed by the Comptroller's rule.

## IV. NO DEFERENCE IS OWED TO THE COMPTROLLER'S ANALYSIS.

No deference is owed to the Comptroller's interpretation of the statute or to its rules interpreting the statute because the statute is not ambiguous, and the Comptroller's interpretation of the statute is erroneous and inconsistent with the legislative intent shown by the plain language.

### A. The COGS Statute is Not Ambiguous.

No deference is owed to any Comptroller policy unless the statutory provision is first deemed to be ambiguous. *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, 2015 Tex. App. LEXIS 4388, *7 (Tex. App.—Austin Apr. 30, 2015, no. pet. h.) (ambiguity is "a precondition to deference") (citing *Combs v. Roark Amusement & Vending, L.P.*, 422 S.W.3d 632, 635 (Tex. 2013) (describing agency-deference doctrine)). This Court has already concluded that section 171.1012 is unambiguous and, more specifically, that the statute's definition of "production" is not ambiguous. *Id.* at *17; *Newpark*, 422 S.W.3d at 56 n.9. Hence, it is inappropriate to defer to the Comptroller in this case.

Moreover, the Comptroller's perceived ambiguity is based on his misunderstanding of the statute's plain language. *See Appellants' Brief*, pg. 17-20. He argues that section 171.1012 is ambiguous because it does not define "installation" nor explain how to treat "mixed transactions." *Id.* at pg. 18-19. The answer to both issues is simple: our Legislature did not intend any limitations based on these terms. The Comptroller's "production" definition and his "mixed transaction" provision should be rejected as contrary to the statute. *See infra*, Argument III.B.; *see also Hallmark Mktg. Co., LLC v. Hegar*, 488 S.W.3d 795, 799, 801 (Tex. 2013). (recognizing that Comptroller likely claimed a statutory ambiguity existed when it did not because that "is the quickest path to administrative deference"; rejecting Comptroller's arguments and holding in taxpayer's favor that the "perceived ambiguity has no bearing on this case. . . . [The statute] means just what it says," and "'an agency's opinion cannot change plain language.'") (quoting *Combs v. Health Care Servs. Corp.*, 401 S.W.3d 623, 630 (Tex. 2013)).

### B. The Comptroller's Position Ignores Economic Reality and Is Inconsistent with the Statutory Text.

No deference is owed to an agency's policy that "is plainly erroneous or inconsistent" with the controlling statute. *Roark*, 422 S.W.3d at 635 and n.10; *USA Waste Servs., Inc. v. Strayhorn*, 150 S.W.3d 491, 494 (Tex. App.—Austin 2004, pet. denied). In construing a statute, the primary objective is to ascertain and to give effect to the legislative intent by first considering the statute's plain language. *Newpark*, 422 S.W.3d at 49. Courts should reject any attempt to read words or requirements into the statute that were not intended by our Legislature. *Zimmer US, Inc. v. Combs*, 368 S.W.3d 579, 587 (Tex. App.—Austin 2012, no pet.).

Additionally, "'[t]axing statutes are construed strictly against the taxing authority and liberally for the taxpayer." *Am. Multi-Cinema*, 2015 Tex. App. LEXIS 4388 at *7.

The United States Supreme Court, Texas Supreme Court, and this Court have all made clear that "statutory determinations in tax disputes should reflect the economic realities of the transactions in issue." *Roark*, 422 S.W.3d at 637 and n.14 (rejecting Comptroller's argument that the transfer of a plush toy was not an integral part of crane-amusement game because argument ignored the economic reality that customers would not play game but for the possibility of winning a toy) (collecting supportive US Supreme Court cases); *see also PPL Corp. v. Comm'r*, 133 S. Ct. 1897, 1905 (2013) (recognizing that it is a "black-letter principle that 'tax law deals in economic realities, not legal abstractions'"); *Rent-A-Center, Inc. v. Hegar*, 468 S.W.3d 220, 224 (Tex. App.—Austin 2015, no pet.) (rejecting Comptroller's mischaracterization of taxpayer's business, which elevated form over substance); *Gulf Chem. & Metallurgical Corp. v. Hegar*, 460 S.W.3d 743, 750 n.10 (Tex. App.—Austin 2015, no pet.) (rejecting the Comptroller's over-reliance on particular labels in books and records, focusing instead on "the substance of the transactions."). Our Legislature has also recognized this tenant of statutory construction. *See* Tex. Gov't

Code § 311.023(5) (courts may consider consequences of particular construction when construing statute).

These authorities teach a common lesson: Interpretations of the Texas Tax Code should not be hyper-technical or draconian. Rather, courts should apply the plain language in a straightforward manner that does not unduly burden the taxpayer or disrupt business conducted in this State. The Comptroller's interpretation of section 171.1012 does not comport with these principles.

First, most businesses maintain their accounting records by overall business functions and/or locations. They do not maintain accounts parsed between integrated activities or sub-components of an activity within a single transaction. As the record in Gulf Copper's appeal will show, the Comptroller's rules force taxpayers to parse their books in this unintended manner, creating an administrative nightmare for Texas businesses and resulting in a second set of books that serve no legitimate business function (such as profitability forecasting or federal income tax reporting). It is not reasonable to conclude that our Legislature intended to impose such a burdensome and time-consuming process on Texas taxpayers, especially after they have already invested a substantial amount of time to calculate their federal income tax amounts, which provide the starting point for the Texas COGS calculation.

Second, if the Comptroller's parsed cost categories were used to disallow deduction of all costs the Comptroller believes to be "service" related (*i.e.*, beneficial in any manner), it would unduly restrict the amount of qualifying taxpayers' COGS deductions. This would result in a tax on more than a company's "margin" as intended by our Legislature. Because the statute requires taxpayers (including all members of a combined group) to apply a single type of deduction, it must be calculated in a manner that fairly arrives at a tax on the business's margin/gross profits. This is possible only when all of the statutorily-allowed costs (including service-related costs) are included in the calculation.

## **PRAYER**

Amici Taxpayers pray that this Court affirm the district court's judgment in favor of Autohaus LP, LLP. In so doing, the Amici Taxpayers pray that this Court adopt their analysis of section 171.1012, as set forth above, to decide the disputed matters in this case and to apply as precedent in future franchise tax disputes.

Respectfully submitted,

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## CERTIFICATE OF COMPLIANCE

I certify that this Amici Curiae Brief complies with the typeface requirements of Tex. R. App. P. 9.4(e) because it has been prepared in a conventional typeface no smaller than 14-point for text and 12-point for footnotes. This document also complies with the word-count limitations of Tex. R. App. P. 9.4(i) because, according to the word count tool of the computer program used to prepare this document, it contains **12,301** words, excluding any parts exempted by Tex. R. App. P. 9.4(i)(1).

*/s/ Amanda Taylor*
Amanda Taylor

## CERTIFICATE OF SERVICE

Pursuant to the Texas Rule of Appellate Procedure 9.5, a true and correct copy of the foregoing was served on all counsel below via e-service on the 25 day of August 2016.

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# [Am. Multi-Cinema, Inc. v. Hegar]

Court of Appeals of Texas, Third District, Austin

April 30, 2015, Filed

NO. 03-14-00397-CV

**Reporter**

2015 Tex. App. LEXIS 4388

Appellant, American Multi-Cinema, Inc. // Cross-Appellants, Glenn Hegar, Comptroller of Public Accounts of the State of Texas; and Ken Paxton, Attorney General of the State of Texas v. Appellees, Glenn Hegar, Comptroller of Public Accounts of the State of Texas; and Ken Paxton, Attorney General of the State of Texas // Cross-Appellee, American Multi-Cinema, Inc.

**Prior History: [*1]** FROM THE DISTRICT COURT OF TRAVIS COUNTY, 200TH JUDICIAL DISTRICT. NO. D-1-GN-12-003831, HONORABLE ORLINDA NARANJO, JUDGE PRESIDING.

**Disposition:** Affirmed in Part; Reversed and Rendered in Part.

## Case Summary

### Overview

HOLDINGS: [1]-Tangible personal property as defined in *Tex. Tax Code Ann. § 171.1012(a)(3)(A)(i)* included a film distributor's exhibitions of films, which meant the exhibitions fell within the definition of goods in *§ 171.1012(a)(1)*, and therefore the film distributor was entitled to subtract its exhibition expenses as a cost of goods sold under *Tex. Tax Code Ann. § 171.101* to determine the taxable margin for franchise tax calculation; [2]-Because the entire auditorium space was used in production as defined in *§ 171.1012(a)(2)*, under which production space and consumption space were not mutually exclusive, the film distributor could calculate the costs based on the entire square footage of its auditoriums and was not limited to the costs associated with the square footage housing the speakers and screens in the auditoriums.

### Outcome

Affirmed in part; reversed and rendered in part.

**Counsel:** For Appellee: Mr. Charles K. Eldred, Assistant Attorney General, Financial Litigation, Tax, and Charitable Trusts Division, Austin, TX.

For Appellant: Ms. Olga Goldberg, Mr. Doug Sigel, Mr. Mark W. Eidman, Ryan Law Firm LLP, Austin, TX.

**Judges:** Before Chief Justice Rose, Justices Goodwin and Field.

**Opinion by:** Melissa Goodwin

## Opinion

### MEMORANDUM OPINION

Appellant cross-appellee American Multi-Cinema, Inc. (AMC) sued appellees cross-appellants the Comptroller of Public Accounts and the Attorney General (collectively the

Comptroller)[1] to recover franchise taxes paid under protest for report years 2008 and 2009. *See* Tex. Tax Code §§ 112.051-.060, 171.001-.1012. The case was tried before the bench in two phases. The Comptroller appeals the trial court's ruling in phase one, and AMC appeals the trial court's ruling in phase two. For the reasons that follow, we affirm the trial court's judgment in part and reverse and render in part.

## BACKGROUND

AMC is in the movie theater business, primarily exhibiting films and other content to its customers. For tax report years 2008 and 2009, AMC determined its taxable **[*2]** margin for purposes of calculating its Texas franchise tax by subtracting its cost of goods sold (COGS) from its total revenue. *See id.* §§ 171.101 (allowing taxable entity to subtract cost of goods sold to determine taxable margin for franchise tax calculation), .1012 (addressing how cost of goods sold determined); *see generally* Combs v. Newpark Res., Inc., 422 S.W.3d 46, 47-8 (Tex. App.—Austin 2013, no pet.) (describing structure and formula for calculating franchise tax, which is "tax on the value and privilege of doing business in Texas" (citing In re Nestle USA, Inc., 387 S.W.3d 610, 612 (Tex. 2012) (orig. proceeding))). AMC included its costs of exhibiting films and other content (exhibition costs) as COGS for those years. *See* Tex. Tax Code § 171.1012(c) (including "all direct costs of acquiring or producing the goods" as COGS). After an audit, the Comptroller disallowed those costs, resulting in AMC's owing additional franchise taxes. AMC paid the additional franchise taxes under protest and brought this suit, asserting that its exhibition costs were properly included in the COGS subtraction. *See id.* §§ 171.101, .1012.

The parties agreed to a bifurcated bench trial. In phase one, the trial court considered whether AMC was entitled to include its exhibition costs in its COGS subtraction. *See id.* § 171.1012. The parties disputed whether AMC's product amounts to a "good" as **[*3]** that term is defined in section 171.1012(a) of the Tax Code. *See id.* § 171.1012(a). "'Goods' means real or tangible personal property sold in the ordinary course of business of a taxable entity." *Id.* § 171.1012(a)(1). Among other definitions, the statute defines "tangible personal property" to mean:

> (i) personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner;
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> (ii) 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.

*Id.* § 171.1012(a)(3)(A)(i), (ii).[2] "'Tangible personal property' does not include: (i) intangible property; or (ii) services." *Id.* § 171.1012(a)(3)(B).

To support its position that its product falls within the definition of "goods" **[*4]** in section

[1] Glenn Hegar, in his official capacity as the Texas Comptroller of Public Accounts, is substituted for Susan Combs, and Ken Paxton, in his official capacity as the Attorney General, is substituted for Greg Abbott. *See* Tex. R. App. P. 7.2(a).

[2] The statute also defines "tangible personal property" as "a computer program, as defined by Section 151.0031." Tex. Tax Code § 171.1012(a)(3)(A)(iii).

*171.1012*, AMC called two of its vice presidents who testified about AMC's business, its film product, and AMC's "production steps" from the time it receives a film from a movie studio to exhibiting the film. To support his position that AMC's product does not constitute "goods," the Comptroller called an entertainment lawyer who testified about the film industry, the types of businesses within that industry—film producers, distribution companies, and film exhibitors—and the meaning of terms in the industry such as "film production" and "film distribution." According to the Comptroller's witness, AMC is not a film producer or distributor, but a "film exhibition company," and AMC's customers do not purchase goods but "the right to observe the movie in the theater."

After phase one was concluded, the trial court ordered that "AMC was entitled to include the costs to exhibit films to its customers in its Cost of Goods Sold subtraction under *Section 171.1012 of the Tax Code*" and ordered the parties to schedule a date for phase two of the trial "to determine the refund amount." Prior to phase two, the parties reached an agreement delineating the majority of exhibition costs that AMC could include in the COGS subtraction. The parties, **[*5]** however, were unable to agree about certain facility-related costs, such as rent and depreciation, associated with the square footage of AMC's movie theater auditoriums and proceeded to phase two of the trial to resolve this dispute. *See id. § 171.1012(c)* (including within COGS "all direct costs of acquiring or producing the goods," such as depreciation and "cost of renting or leasing equipment, facilities, or real property directly used for the production of the goods").

The parties joined issue on the percentage of the auditorium space that should be considered for determining direct costs of "production." *See id. § 171.1012(a)(2)* (defining "production"), *(c)*. AMC asserted that the costs associated with the entire square footage of its auditoriums should be included in the COGS calculation, and AMC's witness testified about the sight, sound, and the controlled environment in its auditoriums. The Comptroller countered that the only costs that should be included were costs associated with the square footage occupied by the speakers and the screens in the auditoriums. The Comptroller did not call witnesses, supporting its arguments based on the common knowledge of a moviegoer.

The parties stipulated to each side's **[*6]** competing calculation of the amount of AMC's refund, depending on the trial court's resolution of the parties' dispute concerning the allowable percentage of costs related to the auditorium space, as follows:

> If the Court agrees with AMC's position that 67.67% of the disputed costs qualify, the tax refund amounts due Plaintiff are $579,656 for Report Year 2008 and $591,293 for Report Year 2009. If the Court agrees with Defendants' position that 13.42% of the disputed costs qualify, the tax refund amount[s] due Plaintiff are $229,709 for Report Year 2008 and $269,959 for Report Year 2009. Plaintiff is also due assessed penalty, assessed interest, and statutory interest.

In its final judgment, the trial court agreed with the Comptroller as to the costs associated with the amount of the auditoriums' square footage that should be included and ordered refunds based on the corresponding stipulated amounts for report years 2008 and 2009. The trial court ordered the Comptroller to issue one or more refund warrants to AMC in the amount of $499,668 in franchise tax, plus appropriate interest and penalties. The trial court also made separate findings of fact and conclusions of law as to both phases of the **[*7]** trial. These cross-appeals followed.

## STANDARDS OF REVIEW

The parties' issues concern statutory construction, a question of law that we review de novo. *See* First Am. Title Ins. Co. v. Combs, 258 S.W.3d 627, 631 (Tex. 2008). Our primary concern in construing a statute is the express statutory language. *See* Galbraith Eng'g Consultants, Inc. v. Pochucha, 290 S.W.3d 863, 867 (Tex. 2009). "We thus construe the text according to its plain and common meaning unless a contrary intention is apparent from the context or unless such a construction leads to absurd results." Presidio Indep. Sch. Dist. v. Scott, 309 S.W.3d 927, 930 (Tex. 2010) (citing City of Rockwall v. Hughes, 246 S.W.3d 621, 625-26 (Tex. 2008)). We "'read the statute as a whole and interpret it to give effect to every part.'" Railroad Comm'n of Tex. v. Texas Citizens for a Safe Future & Clean Water, 336 S.W.3d 619, 628 (Tex. 2011) (quoting City of San Antonio v. City of Boerne, 111 S.W.3d 22, 25 (Tex. 2003)). Further, a precondition to deference to an agency's interpretation of a statute is ambiguity. *See* Combs v. Roark Amusement & Vending, L.P., 422 S.W.3d 632, 635 (Tex. 2013) (describing agency-deference doctrine); Combs v. Health Care Servs. Corp., 401 S.W.3d 623, 629-30 (Tex. 2013) (same). And "[t]axing statutes are construed strictly against the taxing authority and liberally for the taxpayer." *See* Morris v. Houston Indep. Sch. Dist., 388 S.W.3d 310, 313 (Tex. 2012).

The parties also challenge the trial court's findings of fact and conclusions of law. We review the trial court's findings of fact for legal and factual sufficiency of the evidence by the same standard applied to a jury verdict. Ortiz v. Jones, 917 S.W.2d 770, 772 (Tex. 1996); Anderson v. City of Seven Points, 806 S.W.2d 791, 794 (Tex. 1991); *see* City of Keller v. Wilson, 168 S.W.3d 802, 827-28 (Tex. 2005) (describing legal sufficiency standard of review); Cain v. Bain, 709 S.W.2d 175, 176 (Tex. 1986) (describing factual sufficiency standard of review). We review a trial court's conclusions of law de novo to determine their correctness. **[*8]** BMC Software Belg., N.V. v. Marchand, 83 S.W.3d 789, 794 (Tex. 2002). "But we will not reverse an erroneous conclusion if the trial court rendered the proper judgment." City of Austin v. Whittington, 384 S.W.3d 766, 779 n.10 (Tex. 2012); *see* BMC Software, 83 S.W.3d at 794.

## ANALYSIS

### Comptroller's Cross-Appeal

In his cross-appeal, the Comptroller asserts in one issue that the trial court erred in concluding that AMC may include its exhibition costs in its COGS subtraction under section 171.1012 of the Tax Code for report years 2008 and 2009. *See* Tex. Tax Code § 171.1012. According to the Comptroller, exhibiting films does not constitute a "good" because AMC does not sell "tangible personal property" but intangible property, or a film-watching service, or non-property. *See id.* § 171.1012(a)(1) (defining "goods" to include "tangible personal property"), (3)(A) (defining "tangible personal property"), (3)(B) (excluding "intangible property" and "services" from definition of "tangible personal property").

As part of his issue, the Comptroller challenges the legal sufficiency of the evidence to support the trial court's finding of fact no. 4, which states:

> When AMC exhibits movies and other content to its paying customers, it produces personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner for sale in its ordinary course of business.

This finding of fact **[*9]** tracks the definition of "tangible personal property" in chapter 171 of the Tax Code. *See id.* § 171.1012(a)(3)(A)(i).

The Comptroller also challenges the trial court's conclusion of law no. 2, which states:

> When AMC exhibits movies and other content to its paying customers, AMC produces goods for sale in the ordinary course of business under Section 171.1012, and may therefore include the costs of exhibiting movies and other content to its paying customers in its cost-of-goods-sold deduction under Section 171.1012 of the Texas Tax Code.

*See id.* § 171.1012(a)(1) (defining "goods"), (b) (allowing taxable entity to subtract its cost-of-goods-sold for purpose of determining taxable margin), (c) (including "all direct costs of acquiring or producing the goods" as COGS).

The Comptroller's issue turns on the meaning of "goods" as that term is defined in section 171.1012(a)(1). *See* Roark Amusement, 422 S.W.3d at 636 ("If a term is expressly defined by statute, [courts] must follow that definition."); Entergy Gulf States, Inc. v. Summers, 282 S.W.3d 433, 437 (Tex. 2009) ("We do not look to the ordinary, or commonly understood meaning of the term because the Legislature has supplied its own definition, which we are bound to follow." (citing Tex. Gov't Code § 311.011(b))). As previously stated, subsection (a)(1) of section 171.1012 defines "goods" to mean "tangible personal property sold in the ordinary course of business of a taxable entity." **[*10]** Subsection (a)(3)(A)(i) defines "tangible personal property" broadly to mean "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner." Tex. Tax Code § 171.1012(a)(3)(A)(i). The parties do not assert, nor do we find, that this language of section 171.1012 is ambiguous. Thus, we construe the text of the statutory definitions according to its "plain and common meaning." *See* Scott, 309 S.W.3d at 930.

The legislature defined "tangible personal property" to include "personal property" that can be "seen" or "that is perceptible to the senses in any other manner." *See* Tex. Tax Code § 171.1012(a)(3)(A)(i); TGS-NOPEC Geophysical Co. v. Combs, 340 S.W.3d 432, 439 (Tex. 2011) ("We presume that the Legislature chooses a statute's language with care, including each word chosen for a purpose, while purposefully omitting words not chosen."). The legislature did not define "personal property," so we interpret that phrase based on its common meaning. *See* Scott, 309 S.W.3d at 930. "Personal property" means "property other than real property consisting in general of things temporary or moveable." *Webster's Third New Int'l Dictionary* 1687 (2002). Further, "seen" is the past participle of "see," "see" means to "perceive by the eye," *id.* at 2054, and "perceive" means "to become aware of through the senses." *Id.* at 1675.

AMC presented evidence to support its position **[*11]** that its film product falls within the statutory definition of "tangible personal property." AMC's witnesses described AMC as a film distributor and its film product as "a tangible product visible to the sight and sound—perceptible to sound," and as "creative content that is consumed." One of AMC's witnesses described its film product and the process from the time that AMC receives a film to the time the film is shown in AMC's theaters as follows:

> The film comes in to us in multiple parts, multiple pieces, from multiple locations. We take that 35-millimeter film. We construct. We assemble. We put the advertisements. We put the public service announcements. We put the trailers. We put the feature film. We put the cues for the lights, the curtains, all in one contiguous piece of 35-millimeter celluloid film.
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> Once we've constructed—assembled it if

> it's damaged in any way, we may remove any damaged parts simply by cutting them out and splicing them back together. We then install that on a platter. That is then fed through a 35-millimeter projector. Then those images are produced on a screen for the sight and sound consumption of our guests.

The witness also answered "Yes" when asked: "Applying **[*12]** the specific definition from our legislature, is the movie that's projected on the screen tangible personal property?" AMC's evidence included excerpts from the deposition of a representative of the Comptroller who agreed that "a movie on the big-big screen would meet the definition of (3)(A)(i)."

The Comptroller argues that AMC's product does not fall within the meaning of "tangible personal property" because it is either "intangible property" or a movie-viewing "service." *See* Tex. Tax Code § 171.1012(a)(3)(B) (excluding "intangible property" and "services" from definition of "tangible personal property"). Because the statute does not define "intangible property" or "services," we apply their common and ordinary meanings. *See* Scott, 309 S.W.3d at 930. "Intangible property" means "property having no physical substance apparent to the senses: incorporeal property (as choses in action) often evidenced by documents (as stocks, bonds, notes, judgments, franchises) having no intrinsic value or by rights of action, easements, goodwill, trade secrets." *Webster's* at 1173. "'[S]ervice' is defined as "the performance of work commanded or paid for by another." Newpark, 422 S.W.3d at 54 n.8 (defining "service" according to common meaning in context of section 171.1012 and citing definition in *Webster's*); *see also Webster's* at 2075 (defining **[*13]** "service," among other meanings, as "useful labor that does not produce a tangible commodity"), 458 (defining commodity as "economic good").

According to the Comptroller, AMC does not sell the film, but the right to watch the film at a certain time and place. The Comptroller focuses on the customer's purchase of a ticket, which the Comptroller contends is a license, and the fact that AMC's customers leave AMC's theaters with experiences and memories but without a copy of the film. *See* Rylander v. Bandag Licensing Corp., 18 S.W.3d 296, 298 (Tex. App.—Austin 2000, pet. denied) (describing licensing of patents as intangible property rights); Jordan v. Concho Theatres, 160 S.W.2d 275, 276 (Tex. Civ. App.—El Paso 1941, no writ) ("A ticket to a theatre is a mere revocable license."). But the definition of "tangible personal property" in section 171.1012 does not have a take-home requirement. *See* Roark Amusement, 422 S.W.3d at 637 (declining to engraft extra-statutory requirements "under the guise of interpreting it").

Further, the Comptroller's characterization of AMC's film exhibition as "intangible property" and "services" conflicts with section 171.1012(a)(3)(A)(ii), which provides that "tangible personal property" also means:

> 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 **[*14]** 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.

Tex. Tax Code § 171.1012(a)(3)(A)(ii). This subsection makes clear that for purposes of the COGS calculation, "tangible personal property" includes films "without regard to the means or methods of distribution or the medium in which the property is embodied." *See id.*; Roark Amusement, 422 S.W.3d at 636 (requiring court to follow statutory definition of term); Texas Citizens, 336 S.W.3d at 628 (construing statute as whole).[3]

Although the Comptroller presented evidence to support his position that AMC's product was not "tangible personal property," it was within the province of the trial court to resolve conflicts in the evidence in favor of AMC. *See* City of Keller, 168 S.W.3d at 819-20. Applying the plain meaning of "tangible personal property" as that phrase is defined in section 171.1012(a)(3)(A)(i) and viewing **[*15]** the evidence under the applicable standard of review, we conclude that the evidence was legally sufficient to support the trial court's finding of fact no. 4. *See* id. at 827-28. Given this conclusion, we also conclude that the trial court did not err in concluding that AMC was entitled to include its exhibition costs in its COGS subtraction. *See* BMC Software, 83 S.W.3d at 794. Thus, we overrule the Comptroller's issue on cross-appeal.[4]

### AMC's appeal

In one issue, AMC challenges the trial court's ruling in phase two that only AMC's costs associated with the square footage housing the speakers and screens in AMC's auditoriums qualified as **[*17]** COGS under section 171.1012. AMC contends that the trial court erred in deferring to the Comptroller's interpretation of section 171.1012 to determine the amount of franchise taxes owed and that the "undisputed evidence conclusively proved that costs associated with the entire auditorium were direct costs of producing the films AMC sells to its customers." *See* Tex. Tax Code § 171.1012(c). AMC urges that it "uses the entire auditorium space in 'production,' as unambiguously defined by Tax Code section 171.1012(a)(2)." *See id.* § 171.1012(a)(2).

As part of its issue, AMC challenges the trial court's conclusion of law no. 3, which states:

> Interpretations given to statutes by state agencies are entitled to deference when, as here, a tax arguably applied and the court is weighing competing interpretations of the amount owed. The Comptroller's

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[3] One of AMC's witnesses answered "Yes" when asked: "Is that actual screen up there—what I'll call the big screen—is it kind of a medium on which the movie is embodied?" He also testified that AMC mass distributes films.

[4] The Comptroller urges that AMC is limited on appeal to its theory under subsection (a)(3)(A)(i) of section 171.1012 because the trial court only made findings of facts as to that subsection. *See* Tex. R. Civ. P. 298 (addressing requests for amended or additional findings), 299 (addressing omitted findings). Although we need not reach this argument because we have concluded that the evidence was sufficient to support the trial court's finding that AMC's product is "tangible personal property" as defined in subsection (a)(3)(A)(i), we note that a trial court generally is not required to make additional findings "if the requested findings will not result in a different judgment." *See* Flanary v. Mills, 150 S.W.3d 785, 792 (Tex. App.—Austin 2004, pet. denied); *see also* Associated Tel. Directory Publishers, Inc. v. Five D's Publ'g Co., 849 S.W.2d 894, 901 (Tex. App.—Austin 1993, no writ) ("A trial court is not required to set out in detail every reason or theory by which it arrived at its final conclusions.").

AMC also cites **[*16]** a subsequent amendment to section 171.1012 to support its position that its exhibition costs may be included in its COGS subtraction under subsection 171.1012. *See* Act of June 14, 2013, 83d Leg., R.S., ch. 1232, § 10, 2013 Tex. Sess. Law Serv. 3105, 3109 (current version at Tex. Tax Code § 171.1012(t)). Subsection (t) now states:

> If a taxable entity that is a movie theater elects to subtract cost of goods sold, the cost of goods sold for the taxable entity shall be the costs described by this section in relation 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.

*Id.* The Comptroller agrees that AMC may include its exhibition costs based on subsection (t) going forward. Because we uphold the trial court's ruling in phase one based on the plain meaning of "tangible personal property" as defined in section 171.1012 and our review of the evidence, however, we do not address the subsequent amendment to the statute in our analysis as to report years 2008 and 2009.

> interpretation of the amount owed in the present case is reasonable under the plain language of Section 171.1012, Tax Code.

AMC argues that the trial court erred by deferring to the Comptroller's interpretation of the statute because section 171.1012(a)(2), which defines "production," is not ambiguous. *See id.* We agree. Thus, we conclude that the trial court erred by concluding that the Comptroller's interpretation was entitled to deference. *See* Roark Amusement, 422 S.W.3d at 635 (requiring ambiguity as precondition to deferring to agency's **[*18]** interpretation of statute). The issue then is whether the "trial court rendered the proper judgment" as to the amount of refund owed to AMC despite this erroneous conclusion of law. *See* Whittington, 384 S.W.3d at 779 n.10; BMC Software, 83 S.W.3d at 794.

In this context, AMC challenges the trial court's finding of fact no. 8, and relatedly nos. 7, 9, and 10, which address AMC's exhibition costs and the amount of AMC's refund for report years 2008 and 2009 based on those costs. The challenged findings state:

> 7. 13.42% of the Disputed Costs are exhibition costs. This includes 75% of the costs associated with the square footage used to sell concessions, which the parties stipulate is 2.19% of the Disputed Costs. This also includes 100% of the costs associated with the square footage used to project the movies and alternative content into the auditorium, which the parties stipulate is 9.67% of the Disputed Costs. Finally, this includes 100% of the costs associated with the square footage of AMC's auditoriums housing the speakers and screens, which the parties stipulate is 1.56% of the Disputed Costs. This adds up to 13.42% of the Disputed Costs.
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> 8. The costs associated with the square footage for the auditoriums, other than the square footage housing the **[*19]** speakers and screens, are not exhibition costs.
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> 9. Based on 13.42% of the AMC's cost-of-goods-sold for Report Year 2008 is $1,091,269,621. AMC's refund for Report Year 2008 is $229,709, plus assessed interest, penalty, and statutory interest.
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> 10. AMC's cost-of-goods sold for Report Year 2009 is $1,108,701,467. AMC's refund for Report Year 2009 is $269,959, plus assessed interest, penalty, and statutory interest.

The percentages of the disputed costs associated with the square footage of the auditoriums and the corresponding amounts of refunds in findings nos. 7, 9, and 10 follow from the parties' stipulations in the event that the trial court ruled in favor of the Comptroller as to the parties' dispute about costs associated with AMC's auditorium space.

AMC contends that finding of fact no. 8 is erroneous because it is not based on evidence offered at trial and, therefore, that the trial court's related findings based on the parties' stipulations as to the Comptroller's calculations of the amounts owed also are erroneous. According to AMC, its evidence "established that the auditorium is integral to the visual and acoustic production" and that it uses the entire auditorium space in "production" **[*20]** as that term is defined in section 171.1012(a)(2). *See* Tex. Tax Code § 171.1012(a)(2); Roark Amusement, 422 S.W.3d at 636; Entergy, 282 S.W.3d at 437. Section 171.1012(a)(2) defines "production" broadly to include "construction, installation, manufacture, development, mining, extraction, improvement, creation, raising, or growth." Tex. Tax Code § 171.1012(a)(2); *see* Tex. Gov't Code § 311.005(13) (use of word "includes" is term of enlargement and "not of limitation or exclusive enumeration"); *see also* Tex. Tax Code § 171.1012(c) (defining COGS to "include[] all direct costs of acquiring or producing the goods"). Relevant to this appeal, the words "creation" and "improvement" are not defined in the statute so we apply their common meanings. *See* [Scott, 309 S.W.3d at 930]. "Create" means "to bring into existence," *Webster's* at 532, and "improve" means "to make greater in amount or degree" and "to enhance in value or quality." *Id.* at 1138.

AMC's witness in phase two testified about AMC's "improvement" and "creation" of its film product in its auditorium space. He testified about the sight, sound, and lighting in the auditorium space and described the way that AMC sets up this space "both from an acoustic integrity perspective and the way we—what we call EQ, or equalized each of those cinema auditorium spaces." He testified as follows:

> Certainly, we improved on what we're originally provided by our studio partners because if we did not, if you were to go to **[*21]** one of our theaters and that auditorium did not have an auditorium specific sound EQ or equalization, the dialogue would not be as intelligible, the surround coverage and the associate of what we call SPLs or sound pressure levels, some of them would be too loud; some of them would be too high or hot as we call it. You might not have enough low frequency.
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> We definitely change what we are originally providing from our studio partners and we create a unique audio and visual experience.
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> Now, on the visual side, we do it specific to the screen type. The screen gave basically what type of screen vinyl is used in the auditorium, what type of projector is used.
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> Everything has to be combined and that combination is what really creates the unique auditorium specific entertainment experience.
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> A lot of the overall auditorium design is driven by, I mean, on the audio side, how many surrounds we need, what the spacial distance, physical distance between surround so that every patron gets equivalent and equal quality and coverage. The screen—both the screen type, the screen game, the screen size, everything is—they are all taken into account to where we meet, you know, both competitive and technology **[*22]** industry standards. . . .
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> So everything is taken into account, and truly, we are realtime changing what comes out of the projection booth based on what's in the auditorium.
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> . . . .
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> There are literally dozens and dozens and dozens of different technical elements that go into the design and the eventual implementation inside each theater auditorium.

AMC's witness also answered "Yes" when asked if the auditorium was "directly used for production." He further described the auditorium space as "an acoustic chamber," "production area" and "controlled environment with multi dimensional surround audio" and testified that "there is creation going on in that auditorium in near realtime."

During phase two, the Comptroller asserted facts based on the common experiences of moviegoers.[5] The Comptroller's counsel argued in his opening statement:

> And, honestly, Judge, I don't even think you

[5] Similarly, the Comptroller argues on appeal that "the facts needed to decide this appeal are common knowledge to anyone who watches movies in movie theaters."

need evidence in this case, unless you have never been to a movie theater before, because you know what happen[s] in a movie theater just as well as anyone else does. They can explain in greater detail, but the point for this case is, where is—what they have—when they turned this 35-millimeter film into a product for the **[*23]** customers, where does that happen? It happens in the projectors, the screens, and the speakers. And I don't think anything they can say will change that. What happened in the auditorium is not relevant.

The Comptroller asserted that there is "consumption space" and "production space," that only production space counts, and that the auditoriums are consumption space. According to the Comptroller's position, AMC's "goods"—the "sights and sounds" of the film—"are produced in the screens and speakers" and "experienced, not produced, in the auditoriums."[6] The Comptroller, however, did not call any witnesses to rebut AMC's evidence or otherwise present evidence during phase two regarding the design and function of AMC's auditorium space to support his factual assertions.

The plain text of *section 171.1012(a)(2)* also does not support the Comptroller's theory that production space and consumption space are mutually exclusive. **[*24]** *See Roark Amusement, 422 S.W.3d at 637* (declining to engraft extra-statutory requirements); *City of Rockwall, 246 S.W.3d at 629* (declining to read additional words into statute in construing statute). The definition of "production" does not reference or exclude costs that also are associated with consumption space. *See Cameron v. Terrell & Garrett, Inc., 618 S.W.2d 535, 540 (Tex. 1981)* ("Only when it is necessary to give effect to the clear legislative intent can we insert additional words or requirements into a statutory provision.").

The Comptroller focuses on *subsections (e)(1)* and *(3) of section 171.1012* to support his position that costs associated with the auditorium space, other than the screens and speakers, are not COGS. *Subsections (e)(1)* and *(3)* expressly exclude from COGS "the cost of renting or leasing equipment, facilities, or real property that is not used for the production of the goods" and "distribution costs, including outbound transportation costs." *See Tex. Tax Code § 171.1012(e)(1)*, *(3)*. AMC presented evidence at trial that the space of the entire auditorium was used in the "production"—as that term is defined in *section 171.1012(a)(2)*—of its film product, and the Comptroller did not present evidence to controvert AMC's evidence. *See id. § 171.1012(a)(2)*; *Roark Amusement, 422 S.W.3d at 636* (following definition in statute); *Entergy, 282 S.W.3d at 437* (same).

Applying the plain meaning of "production" as defined in *section 171.1012(a)(2)* and viewing the evidence **[*25]** under the applicable standard of review, we conclude that the evidence was legally and factually insufficient to support the trial court's finding of fact no. 8 and, therefore, its related findings nos. 7, 9, and 10. *See City of Keller, 168 S.W.3d at 827-28*; *Cain, 709 S.W.2d at 176*. AMC's evidence established that its costs associated with the square footage of its auditoriums are direct costs of producing its product, and the Comptroller failed to present controverting evidence. *See Tex. Tax Code § 171.1012(a)(2)*, *(c)*.[7] Thus, we sustain AMC's issue and, based

[6] Both at trial and on appeal, the Comptroller equates the experience of watching a film in a theater with watching a DVD on a television at home.

[7] The parties join issue on whether *subsection (o)* is an alternative ground supporting AMC's position that the costs associated with its auditorium space should be included in the COGS subtraction. *See Tex. Tax Code § 171.1012(o)*. *Subsection (o)* allows taxable entities that primarily distribute or produce films to include expenses related to using the films, as well as producing the films, in their COGS subtraction. *See id.* Because we have concluded that the challenged

on the parties' stipulations as to AMC's calculation of the amount of refund owed, render the judgment that the trial court should have rendered. *See* *Tex. R. App. P. 43.3* (generally requiring appellate court to render judgment trial court should have rendered when reversing trial court's judgment).

**CONCLUSION**

For these reasons, we affirm the trial court's ruling as to phase one, reverse the trial court's ruling as to phase two, and render judgment, pursuant to the parties' stipulations, that AMC is entitled to a refund in the amount of $579,656 for report year 2008 and $591,293 for report year 2009, plus appropriate penalty and interest.

Melissa Goodwin, Justice

Before Chief Justice Rose, Justices Goodwin and Field

Affirmed in Part; Reversed and Rendered in Part

Filed: April 30, 2015

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findings **[*26]** in phase two are not supported by the evidence, we need not address this alternative theory for including AMC's costs associated with its auditorium space as COGS. *See* *Tex. R. App. P. 47.1*.

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*Shepard's*®: Report Content

**Appellate History:**Requested

**Citing Decisions:**None Applied

**Other Citing Sources:**None Applied

**Table Of Authorities:**Not Requested

***Shepard's*®:** **Am. Multi-Cinema, Inc. v. Hegar** 2015 Tex. App. LEXIS 4388: (Tex. App. Austin Apr. 30, 2015)

No subsequent appellate history

## Appellate History (1)

1. **Citation you *Shepardized*™**
   **Am. Multi-Cinema, Inc. v. Hegar**, 2015 Tex. App. LEXIS 4388

   **Court:** Tex. App. Austin | **Date:** Apr. 30, 2015

## Citing Decisions (1)

**Analysis:**"Cited by" (1)

**Headnotes:**HN1 (1)

### Texas Court of Appeals

1. **Hegar v. CGG Veritas Servs. (U.S.), Inc.**, 2016 Tex. App. LEXIS 2439

   **Cited by:**

   ... This Court has recently provided overviews of the current Texas franchise-tax scheme, originally enacted in 2006, which assesses franchise taxes against a taxable entity's "taxable margin." See **American Multi-Cinema v. Hegar , No. 03-14-00397-CV, 2015 Tex. App. LEXIS 4388 , 2015 WL 1967877 (Tex. App.—Austin Apr. 30, 2015, no pet.)** (mem. op.); Titan Transp., LP v. Combs , 433 S.W.3d 625 , 627-29 (Tex. App.—Austin 2014, pet. denied) ; Combs v. Newpark Res., Inc. , 422 S.W.3d 46 , 47-48 ...

   **Court:** Tex. App. Austin | **Date:** Mar. 9, 2016 | **Headnotes**: HN1

## Other Citing Sources: (0)

No documents found in Other Citing Sources:.

## Legend

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# Burgess Poultry Market, Inc. v. United States

U.S. District Court, East. Dist. Tex., Tyler Div.

May 22, 1964

Civil Action No. 4150.

**Reporter**

1964 U.S. Dist. LEXIS 9942; 64-2 U.S. Tax Cas. (CCH) P9515; 14 A.F.T.R.2d (RIA) 5036

Burgess Poultry Market, Inc., Plaintiff v. United States of America, Defendant.

## Case Summary

### Procedural Posture

Plaintiff taxpayer, a corporation, sought review of a decision by the Commissioner of Internal Revenue, which disallowed the taxpayer's claims for refund of certain income taxes and interest assessed and collected, plus interest according to law.

### Overview

For each of the relevant fiscal years, the taxpayer filed timely corporate income tax returns disclosing operating losses and no income tax due. The taxpayer paid alleged deficiencies in income taxes for certain fiscal years. On or about May 20, 1963, the taxpayer filed with the District Director of Internal Revenue claims for refund of said income taxes and interest assessed and collected, plus interest according to law. The court found that the alleged deficiencies in income tax resulted from the erroneous action of the commissioner in computing the taxpayer's taxable income of its farm division on the accrual basis of accounting for certain fiscal years. The court held that the action of the commissioner in computing the taxpayer's taxable income of its farm division on the accrual basis of accounting, and in adjusting the taxpayer's income for ending inventories and ending accounts payable for certain fiscal years, was illegal and erroneous, and the entire deficiencies in income tax and interest paid as a result thereof should be refunded with interest thereon according to law.

### Outcome

The court found that the action of the Commissioner in improperly computing the taxpayer's taxable income was illegal and erroneous and the entire deficiencies in income tax and interest paid as a result thereof should be refunded with interest thereon according to law.

**Opinion by: [*1]** SHEEHY

## Opinion

Findings of Fact and Conclusions of Law

Findings of Fact

SHEEHY, District Judge: 1. The plaintiff in this case is a corporation duly organized November 3, 1953, under the laws of the State of Texas with its principal offices in Nacogdoches, Texas, and is suing to recover federal income taxes and interest alleged to have been erroneously and illegally assessed and collected from it by the defendant for the fiscal years ending October 31, 1960, and October 31, 1961.

2. Since its incorporation in 1953, plaintiff has been engaged in the business of processing and selling broiler chickens, and in connection with that business plaintiff has kept its books and

filed its income tax returns on the accrual basis of accounting. Said books consisted of cash disbursements journal, cash receipts journal, sales journal, voucher register, payroll journal, general journal and general ledger.

3. Plaintiff's broiler processing business generally consisted of procuring live broiler chickens when they were approximately nine weeks old, slaughtering, cleaning and preparing such chickens for market, and selling same both in a fresh and frozen state.

4. On March 15, 1960, plaintiff's **[*2]** Board of Directors met to consider, among other things, the establishment of a farm division. The minutes of that meeting reflect that plaintiff's Board of Directors, among other things, took the following action:

"Be it resolved by the board of directors that the company establish a separate farm operation to grow broilers and use the following procedures:

"1. Use the trade name of "Burgess Poultry Farms" to get apart from the market operations.

"2. Maintain separate accounts and records so that monthly profit and loss statements can be prepared for the farm operation.

"3. Negotiate contracts with growers to feed and provide houses for the chickens under the close supervision of the company.

"Herman Chancellor stated that he would second the motion if Mr. Palmer would amend the resolution by adding a provision that the broilers would be charged to the Market Division at the prevailing prices and that the operation of the farm would not interfere with regular Market Division operations in any way. Parrish Palmer duly amended his resolution, the motion was seconded and passed without a dissenting vote."

5. From its inception, the principal business of plaintiff's **[*3]** farm division was feeding and raising baby chicks for approximately nine weeks, after which time they reached a stage where they were sold as broilers.

6. Sometime after the commencement of plaintiff's farm division, there was added thereto a feed mill which mixed feed to be fed to the growing chickens, a hatchery to provide baby chicks to be raised, and a breeder flock of chickens to provide eggs to the hatchery.

7. From the inception of the farm division and throughout the fiscal years ended October 31, 1960, and October 31, 1961, plaintiff kept a set of books for its farm division operations which consisted of a cash disbursement journal, payroll journal, and general ledger. The books kept for the farm division were completely separate from the books kept for the broiler processing division. The books of the farm division were kept on the cash receipts and disbursements method of accounting and this method was used in reporting plaintiff's income and expenses from its farm division on its federal income tax returns for the fiscal years ended October 31, 1960, and October 31, 1961.

8. Upon commencement of the poultry raising business in its farm division, all new operating **[*4]** employees were hired in the farm division and no employees were transferred to the farm division from the processing division. Throughout the period in question, each division had its own separate employees, including separate bookkeepers and each division paid its own employees out of its own separate bank accounts. Separate bank accounts were maintained by the plaintiff for both its broiler processing division, in the name of Burgess Poultry Market, Inc., and its farm division, in the name of Burgess Poultry Farms in the Commercial National Bank, Nacogdoches, Texas, and the Stone Fort National Bank, Nacogdoches, Texas. Each division handled all its income and expenses

through its own bank accounts in said banks.

9. Mr. T. D. Burgess was President, Director, and principal stockholder (owning approximately 70% of the outstanding stock) of plaintiff during the years in question. He was also general manager of the entire business operations of the plaintiff, including the farm division. Plaintiff's office manager generally supervised all bookkeeping and accounting, including that of the farm division, however, neither he nor Mr. Burgess were required to devote but very little **[*5]** of their time to the operations of the farm division.

10. The business of the farm division is principally conducted from Garrison, Texas, which is approximately 20 miles from Nacogdoches, Texas, where the broiler processing division has its plant.

11. Beginning with the commencement of its farm division in March, 1960, the contracts between plaintiff and its growers, were as follows:

"EFFECTIVE JANUARY 1, 1960 THE FOLLOWING BROILER GUARANTEE WILL BE OFFERED BY BURGESS POULTRY FARMS, NACOGDOCHES, TEXAS

"(1) The following guarantee will be paid to Growers -

Go to Table1

**[*6]**

Go to Table2

13. Plaintiff's purpose in creating **[*7]** a farm division and going into the poultry raising business was to realize a profit on such operations. Though operating losses occurred in the beginning, the overall operations of the farm division to date have been profitable.

14. At all times material to this case, there was an ample supply of broilers available for the purchase by the processing division from outside sources and during the years 1960 and 1961, the purchasers of broilers by the processing division from outside sources amounted to approximately 60% of the total purchases.

15. All transactions between the two divisions were handled by invoice or similar vouchers and payments thereof by check. No transactions between the two divisions were ever handled merely by bookkeeping entry.

16. There was never any shifting or manipulating of income or expenses between the farm division and the processing division of plaintiff.

17. Plaintiff's poultry raising business, carried on through its farm division, is basically similar to numerous other independent poultry raising businesses and is a farming operation.

18. Prior to March, 1960, plaintiff had not engaged in the business of raising broilers for sale **[*8]** and at the time of the formation of the farm division plaintiff commenced a new business.

19. At all times material to this suit, the operations of plaintiff's farm division were separate and distinct from the broiler processing division.

20. During the taxable years involved in this suit, plaintiff could not and did not shift its income and expenses between the divisions and the cash receipts and disbursements method of accounting for plaintiff's farm division business clearly reflected its income.

21. For each of its fiscal years ending October 31, 1960, and October 31, 1961, plaintiff filed timely corporation income tax returns disclosing operating losses and no income tax due. On May 14, 1963, plaintiff paid alleged

deficiencies in income taxes for the fiscal year ending October 31, 1960, in the amount of $ 7,391.50, plus interest thereon in the amount of $ 1,019.73, and for the fiscal year ending October 31, 1961, in the amount of $ 6,292.89, plus interest thereon in the amount of $ 490.59. On or about May 20, 1963, plaintiff filed with the District Director of Internal Revenue, at Dallas, Texas, claims for refund of said income taxes and interest assessed and collected, **[*9]** plus interest according to law. Under date of October 10, 1963, the District Director of Internal Revenue notified plaintiff of the disallowance of said claims by certified mail.

22. The alleged deficiencies in income tax result from the erroneous action of the Commissioner of Internal Revenue in computing plaintiff's taxable income of its farm division on the accrual basis of accounting for the fiscal years ending October 31, 1960, and October 31, 1961. In so doing, for the fiscal year ending October 31, 1960, the Commissioner increased income in the amount of $ 47,415.98 as ending inventory, and decreased income in the amount of $ 5,197.29 as accounts payable at the end of that year. For the fiscal year ending October 31, 1961, the Commissioner increased income in the amount of $ 98,485.38 as the increase in ending inventory for that year, and decreased income in the amount of $ 56,260.36 as the increase in accounts payable at the end of such year.

Conclusions of Law

The Court makes and files the following conclusions of law:

1. The Court has jurisdiction over the parties as well as the subject matter of the action.

2. From its inception and throughout the period **[*10]** involved in this suit, the poultry raising business of plaintiff's farm division was a separate and distinct business from plaintiff's broiler processing business.

3. For federal income tax purposes, plaintiff is entitled to keep its books of account and determine its taxable income from its poultry raising farm business on the cash receipts and disbursements method of accounting and said method of accounting clearly reflects its income.

4. The action of the Commissioner of Internal Revenue in computing plaintiff's taxable income of its farm division on the accrual basis of accounting and in adjusting plaintiff's income for ending inventories and ending accounts payable for the fiscal years ending October 31, 1960, and October 31, 1961, is illegal and erroneous and the entire deficiencies in income tax and interest paid as a result thereof should be refunded with interest thereon according to law.

A judgment in accordance herewith may be entered.

## Table1 (Return to related document text)

| Conversion | Rate Per Bird Sold |
|---|---|
| 43.0 or over | 6 |
| 40.0 to 42.9 | 5 |
| 38.0 to 39.9 | 4 |
| 37.9 or less | 3 |

"(2) The grower will receive 1/2 profits over and above guarantee.

"(3) The grower will pay 1/2 of catching cost regardless of results.

"(4) Burgess Poultry Farms will pay 1/2 gas from January 1 thru March providing; the 1/2 does not exceed.006 (six tenths of a cent per chick) the broiler houses are on separate tanks or metered from residence tank. (Meters are available at a rental cost of $ 5.00 which is to be paid by grower).

"(5) This contract is on a house to house basis.

"(6) Burgess Poultry Farms will pay for the shavings if the guarantee is more than the total profit. The grower will pay for shavings if the profit is more than guarantee.

(a) Grower will wash or spray his own house at his expense.

"(7) The broiler house must be inspected by Burgess Poultry Farms Representatives and floor space must be at least 9/10 of a foot per bird placed.

"(8) Burgess Poultry Farms under this guarantee reserves the right to determine when poultry shall go to market.

"(9) The grower shall sign a mortgage at the time of placement.

"Date:

Grower: …"

BURGESS POULTRY FARMS

Under these contracts plaintiff furnished all chicks, feed, litter and medication required to raise the poultry. In addition, the farm division's representatives controlled all material aspects of the growing operation and determined the

12. All sales of broilers by the farm division were made at the prevailing market price at the time of sale, including all such sales to the processing division of plaintiff. For the fiscal years ending October

| | Rate Per |
|---|---|
| Conversion | Bird Sold |

31, 1960, and October 31, 1961, the processing division of the plaintiff made the following purchases of broilers from the sources set forth below:

time that the chickens would be sold Subsequently, the wording of the contract was revised but the only material changes in the agreement between the plaintiff and its growers concerned the amounts to be paid to the grower for his services.

BROILER PURCHASES

**Table1 (*Return to related document text*)**

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**Table2 (*Return to related document text*)**

| Month | From Farm Division | From Outside Source | Total Purchases |
|---|---|---|---|
| Nov. 1959 | 0 | $ 97,491.89 | $ 97,491.89 |
| Dec. 1959 | 0 | 113,822.48 | 113,822.48 |
| Jan. 1960 | 0 | 141,011.25 | 141,011.25 |
| Feb. 1960 | 0 | 102,247.87 | 102,247.87 |
| Mar. 1960 | 0 | 223,798.80 | 223,798.80 |
| Apr. 1960 | $ 6,174.36 | 147,710.94 | 153,885.30 |
| May 1960 | 23,401.26 | 148,486.17 | 171,887.43 |
| June 1960 | 40,076.51 | 137,775.38 | 177,851.89 |
| July 1960 | 28,508.63 | 115,848.10 | 144,356.73 |
| Aug. 1960 | 72,502.45 | 167,767.84 | 240,270.29 |
| Sept. 1960 | 56,612.71 | 82,825.70 | 139,438.41 |
| Oct. 1960 | 51,562.54 | 118,634.31 | 170,196.85 |
| Nov. 1960 | 34,367.80 | 76,108.65 | 110,476.45 |
| Dec. 1960 | 47,937.56 | 71,123.11 | 119,060.67 |
| Jan. 1961 | 43,199.11 | 79,587.47 | 122,786.58 |
| Feb. 1961 | 37,137.69 | 93,391.96 | 130,529.65 |
| Mar. 1961 | 69,496.85 | 130,963.00 | 200,459.85 |
| Apr. 1961 | 76,556.29 | 72,124.65 | 148,680.94 |
| May 1961 | 67,925.36 | 69,799.10 | 137,724.46 |
| June 1961 | 94,474.10 | 105,041.49 | 199,515.59 |
| July 1961 | $ 90,468.67 | $ 66,824.97 | $ 157,293.64 |
| Aug. 1961 | 108,003.56 | 120,751.47 | 228,755.03 |
| Sept. 1961 | 109,952.22 | 32,160.70 | 142,112.92 |

| Month | From Farm Division | From Outside Source | Total Purchases |
|---|---|---|---|
| Oct. 1961 | 165,775.40 | 59,983.58 | 225,758.98 |

**Table2 (*Return to related document text*)**

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# *Centerpoint Builders GP, LLC v. Trussway, Ltd.*

Supreme Court of Texas

November 2, 2015, Argued; June 17, 2016, Opinion Delivered

No. 14-0650

**Reporter**

2016 Tex. LEXIS 505; 59 Tex. Sup. J. 1295; CCH Prod. Liab. Rep. P19,861

CENTERPOINT BUILDERS GP, LLC AND CENTERPOINT BUILDERS, LTD., PETITIONERS, v. TRUSSWAY, LTD., RESPONDENT

**Notice:** PUBLICATION STATUS PENDING. CONSULT STATE RULES REGARDING PRECEDENTIAL VALUE.

**Prior History: [*1]** ON PETITION FOR REVIEW FROM THE COURT OF APPEALS FOR THE NINTH DISTRICT OF TEXAS. *Centerpoint Builders GP, LLC v. Trussway Ltd., 436 S.W.3d 882, 2014 Tex. App. LEXIS 7458 (Tex. App. Beaumont, 2014)*

## Case Summary

### Overview

HOLDINGS: [1]-A general contractor hired to construct an apartment complex did not show that it was "engaged in the business of" commercially distributing or placing trusses in the stream of commerce and thus it was not a "seller" entitled to seek indemnity under *Tex. Civ. Prac. & Rem. Code Ann. § 82.002(a)* because any sale of trusses was incidental to a contract to provide the services necessary to construct a building; [2]-One is not "engaged in the business of" selling a product for purposes of indemnity if providing that product is incidental to selling services.

### Outcome

Judgment of the court of appeals affirmed.

**Counsel:** For Texas Building Branch-Associated General Contractors of America, Amicus Curiae: James Corbin Van Arsdale, AGC-TBB, Austin TX.

For Centerpoint Builders GP, LLC, Centerpoint Builders, Ltd., Petitioners: Diana L. Faust, R. Brent Cooper, Cooper & Scully, P.C., Dallas TX; John H. Thomisee Jr., Thomisee Law Firm, P.C., Richmond TX.

For Trussway, Ltd., Respondent: Bradley Wayne Snead, Howard L. Close, R. Russell Hollenbeck, Thomas C. Wright, Wright & Close LLP, Houston TX; George P. Pappas, Sheehy, Ware & Pappas, P.C., Houston TX.

**Judges:** JUSTICE LEHRMANN delivered the opinion of the Court, in which CHIEF JUSTICE HECHT, JUSTICE GREEN, JUSTICE WILLETT, JUSTICE GUZMAN, JUSTICE DEVINE, and JUSTICE BROWN joined. JUSTICE BOYD filed a dissenting opinion, in which JUSTICE JOHNSON joined.

**Opinion by:** Debra H. Lehrmann

## Opinion

Texas Civil Practice and Remedies Code chapter 82 entitles the "seller" of a defective product to indemnity from the product manufacturer for certain losses. In this case, the general contractor hired to construct an apartment complex seeks indemnity under chapter 82 from the manufacturer of wooden trusses used in roofing and **[*2]** drywall projects on the site. The sole issue is whether the general contractor qualifies as a truss seller under chapter 82. The trial court held that it does, but the court of appeals disagreed and rendered judgment for the manufacturer on the indemnity claim. Applying chapter 82's definition of "seller," we agree with the court of appeals that the general contractor is not a seller and affirm the court's judgment.

**I**

Glenmont Madison Beaumont LLC hired Centerpoint Builders, Ltd. (now known as Centerpoint Builders, LLC) as the general contractor to build the Beaumont Trace Apartments. Centerpoint subcontracted with McEvers Maverick Builders to install sheetrock and drywall, and with Sandidge & Associates, Inc. to install wooden roof trusses.[1] Centerpoint purchased the trusses directly from their manufacturer, Trussway, Ltd.

The underlying lawsuit arose when Merced Fernandez, an independent contractor hired by Sandidge, stepped onto a truss that had been laid in position but not yet installed. Fernandez was carrying sheetrock while walking across the trusses above the second story. A truss broke and Fernandez **[*3]** fell eight to ten feet, rendering him paraplegic. Fernandez sued Glenmont, Centerpoint, Maverick, Sandidge, and Trussway for, among other related claims, failing to use reasonable and appropriate care to correct, remedy, or warn of an unreasonably unsafe condition on the property, failing to adequately supervise, failing to use good quality building materials, and negligently designing, manufacturing, and testing the truss. Fernandez ultimately settled with all defendants. Centerpoint filed a cross-action against Trussway for statutory indemnity, alleging that Trussway, the truss manufacturer, was legally required to indemnify Centerpoint, the truss seller, for any loss arising from Fernandez's suit. Trussway responded with its own indemnity crossclaim against Centerpoint.

Centerpoint and Trussway filed cross-motions for summary judgment. Centerpoint also sought partial summary judgment on its own claim, arguing that it was a seller under chapter 82 and was entitled to indemnity as a matter of law. The trial court granted Centerpoint's motion as to Trussway's claim. With respect to the motions on Centerpoint's claim, the court held as a matter of law that Centerpoint was a seller under **[*4]** chapter 82, but otherwise denied both parties' requests for summary judgment. The trial court certified its order for interlocutory appeal. *Tex. Civ. Prac. & Rem. Code § 51.014(d)* (allowing a trial court to permit an interlocutory appeal of an otherwise unappealable order if certain conditions are met).

The court of appeals reversed in part, holding that Centerpoint did not fit the statutory definition of a seller and was not eligible to seek indemnity. *436 S.W.3d 882, 888, 2014 Tex. App. LEXIS 7458 (Tex. App.—Beaumont 2014)*. The court of appeals also affirmed the trial court's summary judgment in Centerpoint's favor on Trussway's cross-claim because Centerpoint did not manufacture the truss and therefore was not obligated to indemnify Trussway. *Id. at 889*. Only Centerpoint filed a petition for review, presenting as its sole issue whether the court of appeals erred in holding Centerpoint was not a seller. Centerpoint contends that the court of appeals' analysis conflicts with our opinion in *Fresh Coat, Inc. v.*

[1] Trusses are wooden beams that are nailed together to support a building's roof.

K-2, Inc., 318 S.W.3d 893 (Tex. 2010),[2] and that the trial court correctly recognized Centerpoint's seller status.

## II

The Texas Products Liability Act gives the innocent seller of an allegedly defective product a statutory right to indemnity from the product's manufacturer for losses arising out of a products-liability action. *Petroleum Sols., Inc. v. Head, 454 S.W.3d 482, 491 (Tex. 2014)*. This statutory right is "in addition to any duty to indemnify established by law, contract, or otherwise." *Tex. Civ. Prac. & Rem. Code § 82.002(e)(2)*. In construing the Act, as with any statute, we start with the "ordinary meaning of the statutory text." *In re Ford Motor Co., 442 S.W.3d 265, 271 (Tex. 2014)*. We analyze that language in context, considering the specific sections at issue as well as the statute as a whole. *CHCA Woman's Hosp. v. Lidji, 403 S.W.3d 228, 231-32 (Tex. 2013)*. While we are limited to the statute's text, "we must attempt to give effect to every word and phrase," and we may not omit or gloss over verbiage in an attempt to reclaim clarity. *Abrams v. Jones, 35 S.W.3d 620, 625 (Tex. 2000)*. We "presume[] the Legislature deliberately and purposefully selects words and phrases it enacts, as well as deliberately and purposefully omits words and phrases it does not enact." *Tex. Mut. Ins. Co. v. Ruttiger, 381 S.W.3d 430, 452 (Tex. 2012)*.

The Act's indemnity provision states:

> A manufacturer shall indemnify and hold **[*6]** harmless a seller against loss arising out of a products liability action, except for any loss caused by the seller's negligence, intentional misconduct, or other act or omission, such as negligently modifying or altering the product, for which the seller is independently liable.

*Tex. Civ. Prac. & Rem. Code § 82.002(a)*. "Products liability action" is broadly defined as "any action against a manufacturer or seller for recovery of damages arising out of personal injury, death, or property damage allegedly caused by a defective product." *Id. § 82.001(2)*. The term includes "all direct allegations against the seller that relate to plaintiff's injury." *Meritor Auto., Inc. v. Ruan Leasing Co., 44 S.W.3d 86, 90 (Tex. 2001)*.

We have explained that the "purpose of *section 82.002* is to protect innocent sellers by assigning responsibility for the burden of products-liability litigation to product manufacturers." *Petroleum Sols., 454 S.W.3d at 494*. To that end, the duty to indemnify is triggered by allegations in the injured claimant's pleadings of a defect in the manufacturer's product, regardless of any adjudication of the manufacturer's liability to the claimant. *Gen. Motors Corp. v. Hudiburg Chevrolet, Inc., 199 S.W.3d 249, 255 (Tex. 2006)*; *see Owens & Minor, Inc. v. Ansell Healthcare Prods., Inc., 251 S.W.3d 481, 484 (Tex. 2008)* ("The manufacturer's duty begins when it is given notice that a seller has been sued."). The manufacturer may "escape this duty to indemnify" by proving that the seller's "acts or omissions **[*7]** independent of any defect in the manufactured product cause[d] injury." *Hudiburg, 199 S.W.3d at 252, 255*.

While the scope of a manufacturer's duty to indemnify is often described as broad, it is owed only to sellers, and an indemnity claimant's seller status is a necessary prerequisite to maintaining a claim. *Fitzgerald v. Advanced Spine Fixation Sys., Inc., 996*

[2] We have jurisdiction over interlocutory appeals in which the court of appeals "holds differently from a prior decision of" this Court, meaning "there is inconsistency in the[] respective decisions that should be clarified to remove unnecessary **[*5]** uncertainty in the law and unfairness to litigants." *Tex. Gov't Code § 22.225(c)*, *(e)*. The parties present a genuine dispute about whether the court of appeals correctly applied *Fresh Coat*, revealing uncertainty to be clarified in this area.

S.W.2d 864, 867 (Tex. 1999) ("Anyone who qualifies as a 'seller' may seek indemnification, subject to the limitations of section 82.002(a)."). The Act defines "seller" as "a person who is engaged in the business of distributing or otherwise placing, for any commercial purpose, in the stream of commerce for use or consumption a product or any component part thereof." Tex. Civ. Prac. & Rem. Code § 82.001(3).[3]

The statute does not define the phrase "engaged in the business of." Black's Law Dictionary defines "engaged" as "to employ or involve oneself; to take part in; to embark on." BLACK'S LAW DICTIONARY 646 (10th ed. 2014); State Office of Risk Mgmt. v. Carty, 436 S.W.3d 298, 302 (Tex. 2014) (noting that "[u]ndefined terms in a statute are typically given their ordinary meaning [unless] a different or more precise definition is apparent from the term's use in the context of the statute" (citation and internal quotation marks omitted)). "Business" is defined as a "commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain." BLACK'S LAW DICTIONARY at 239. And the similar phrase "doing business" is defined as "the carrying out of a series of similar acts for the purpose of realizing a pecuniary benefit." *Id.* at 590. Our analysis cannot begin and end with the definitions of individual words, however, because the Legislature used an entire phrase: "engaged **[*9]** in the business of." *See* In re Office of Atty. Gen., 422 S.W.3d 623, 629 (Tex. 2013) ("We must endeavor to read the statute contextually, giving effect to every word, clause, and sentence.").

Centerpoint argues that it is a truss seller entitled to indemnity from the truss manufacturer for Centerpoint's losses arising out of this lawsuit, in which Fernandez alleged in part that a defective truss caused his injuries. Like the court of appeals, our inquiry is limited to Centerpoint's seller status.

## III

### A

Whether a general contractor may seek statutory indemnity as a seller of materials used in a building's construction is an issue of first impression in this Court. We addressed the seller status of a subcontractor in *Fresh Coat* and begin with that case, cited extensively by both the parties and the court of appeals.

Fresh Coat contracted with a homebuilder to install synthetic stucco components (collectively referred to as EIFS, or exterior insulation and finishing system) on the exterior walls of several homes. Fresh Coat, 318 S.W.3d at 895. The contract required Fresh Coat to provide "labor, services and/or materials, equipment, transportation, or facilities" necessary to apply and finish the synthetic stucco. Id. at 899 (internal quotation marks omitted). Fresh Coat purchased EIFS **[*10]** components from their manufacturer and installed them pursuant to Fresh Coat's contract with the builder. Id. at 895. After moving in, more than 90 homeowners sued Fresh Coat, the EIFS manufacturer, and the builder, alleging the EIFS allowed water penetration that damaged

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[3] To the extent any question lingers as to whether the pleadings trigger seller status rather than the facts and evidence, we answer that question in the negative. Our precedent consistently determines seller or manufacturer status based on the evidence, and nothing in section 82.002(a) or the statute's purpose supports allowing the pleadings to dictate whether a party qualifies as a manufacturer or seller. *See, e.g.,* Fresh Coat, 318 S.W.3d at 899 (analyzing the evidence to conclude that Fresh Coat was a seller); Fitzgerald, 996 S.W.2d at 867 (noting that the definition of seller included the petitioner, "who sells spinal fixation devices, a product, for use by its customers"); **[*8]** *see also* Hadley v. Wyeth Labs., Inc., 287 S.W.3d 847, 850 (Tex. App.—Houston [14th Dist.] 2009, pet. denied) (noting that chapter 82's expansion of a seller's indemnity rights by allowing the duty to indemnify to be triggered by allegations "does not suggest an additional legislative intent to also broaden the scope of defendants who are considered sellers").

their homes. *Id.* The builder sought indemnity from Fresh Coat and the manufacturer, and Fresh Coat in turn sought indemnity from the manufacturer. *Id. at 896*. The homeowners settled with all defendants, and Fresh Coat settled with the builder. *Id.* At issue in the court of appeals and this Court was a judgment in Fresh Coat's favor on its indemnity claim against the manufacturer. The builder's indemnity claims were not before us.

The issue pertinent to this case was whether Fresh Coat qualified as a seller. Rejecting the manufacturer's characterization of Fresh Coat as a service provider and not a product seller, we held that chapter 82 "anticipates that a product seller may also provide services" and that a company's "installation services do not preclude it from also being a seller." *Id. at 899*. We agreed with the court of appeals that Fresh Coat presented legally sufficient evidence it was a seller entitled to seek indemnity under chapter 82 **[*11]** even though the stucco was a component part of improved real property, which is not considered a product. *Id. at 898-99*; *see also Restatement (Third) of Torts: Prod. Liab. § 19 cmt. e* (1998) ("Traditionally, courts have been reluctant to impose products liability on sellers of improved real property in that such property does not constitute goods.").

Centerpoint contends that, like Fresh Coat, it is both a product seller and a service provider. It argues that the contract and truss purchase order show that Centerpoint was "in the business of placing the trusses, for a commercial purpose (fulfilling its contract to build the apartment building), into the stream of commerce for use or consumption." Trussway responds that Centerpoint, like most builders, "is 'engaged in the business' of selling construction services," not building materials. For the reasons discussed below, we agree with Trussway.

In holding that Fresh Coat was a seller, we relied in part on witness testimony that the company was "in the business of providing EIFS products combined with the service of EIFS installation."[4] *Fresh Coat, 318 S.W.3d at 899*. But we did not elaborate on the contents of that testimony, instead addressing and rejecting the manufacturer's legal argument that Fresh Coat was *precluded* from being **[*12]** a seller because it also provided installation services. *Id.* Further, the contractor at issue in *Fresh Coat* sold and installed a particular product, and we were not required to consider how and if the analysis would be affected if the person seeking seller status were a general contractor constructing an improvement to real property. Accordingly, we find guidance in case law on more factually similar footing.

**B**

In evaluating Centerpoint's seller status, we do not examine whether Centerpoint has ever sold trusses, but whether Centerpoint is "engaged in the business of" selling trusses. Aside from the court of appeals' opinion in this case, we have found few Texas cases addressing whether a general contractor is a seller of the materials it incorporates into construction projects. But the cases we have found, which typically **[*13]** involve whether a general contractor is a seller for strict-liability purposes, are consistent with the court of appeals' conclusion that Centerpoint is not a seller. In *Barham v. Turner Construction Co. of Texas*, for example, the plaintiff, injured during construction of an office building when a steel column fell and struck his head, sued the general contractor hired to construct the building. *803 S.W.2d 731,*

[4] We also noted that Fresh Coat had installed the EIFS pursuant to the manufacturer's instructions, which was significant in light of *section 82.002(d)*'s recognition that "a wholesale distributor or retail seller who completely or partially assembles a product in accordance with the manufacturer's instructions shall be considered a seller." *Fresh Coat, 318 S.W.3d at 899* (quoting *Tex. Civ. Prac. & Rem. Code § 82.002(d)*). This provision does not apply here.

734 (Tex. App.—Dallas 1990, writ denied). The trial court refused to submit jury questions and instructions on the plaintiff's products-liability claim against the contractor, and the court of appeals agreed, holding that the contractor was not a seller with respect to the steel columns. Id. at 737-38. Examining the distinction between a company in the business of selling its services and a company in the business of selling products, the court explained:

> Turner Construction is in the business of selling its services as a general contractor. We find nothing in the record to indicate that Turner Construction is in the business of selling the steel columns and erection plates which caused Barham's injury. Any alleged "sale" of the steel columns by Turner Construction was incidental to its contract to provide the services necessary to construct a **[*14]** building.

Id. at 738; *cf.* Peterson Homebuilders, Inc. v. Timmons, No. 14-03-00400-CV, 2004 Tex. App. LEXIS 6765, 2004 WL 1660936, at *5 (Tex. App.—Houston [14th Dist.] July 27, 2004, no pet.) (mem. op.) (holding that a subcontractor that built a foundation pad for a house did not owe the general contractor a duty to indemnify because the subcontractor "did not place this structural pad in the stream of commerce").[5]

Case law from other jurisdictions, while sparse, also supports a determination that general contractors typically are not "engaged in the business of" selling or distributing the materials used in constructing a particular improvement. In *Maack v. Resource Design & Construction, Inc.*, homeowners sued the builder for strict liability, alleging that defects in the home's exterior components led to water leaks. 875 P.2d 570, 573 (Utah Ct. App. 1994), *abrogated in part on other grounds by* Davencourt at Pilgrims Landing Homeowners Ass'n v. Davencourt at Pilgrims Landing, LC, 2009 UT 65, 221 P.3d 234 (Utah 2009). The Utah Court of Appeals held that the builder was not a "seller" of the house's exterior component parts, explaining: "The evidence is undisputed that [the contractor and its owner] were construction contractors who simply utilized these component parts when constructing the residence—they were not in the business **[*16]** of selling stucco, adhesives, or membranes on a wholesale or retail basis." Id. at 581; *compare* Fresh Coat, 318 S.W.3d at 899 (noting the evidence that the indemnity claimant was "in the business of providing EIFS products combined with the service of EIFS installation").

Other cases take a similar approach in denying seller status to contractors whose business is providing construction services, not any particular building material that may be utilized in that process. *See, e.g.*, Calloway v. City of Reno, 116 Nev. 250, 993 P.2d 1259, 1272 (Nev. 2000) ("Although a contractor may, as part of a construction or remodeling project, install certain products, a contractor, without doing more, is not engaged in the business of

[5] We recognize that the issue in many of these cases was whether the plaintiff could maintain a common-law strict-liability claim against a general contractor as a seller, not whether the contractor could bring a statutory-indemnity claim as a seller. *E.g.*, Barham, 803 S.W.2d at 734. However, the Legislature chose to define "seller" in chapter 82 just as we have construed the term for strict-liability purposes. Strict liability is limited to those "engaged in the business of selling" a product, which we have long interpreted to include those "engaged in the business of introducing the products into channels of commerce." Armstrong Rubber Co. v. Urquidez, 570 S.W.2d 374, 375 (Tex. 1978). "Seller" in turn is defined in the Products Liability Act as "a person who is engaged in the business of distributing or otherwise placing, for any commercial purpose, in the stream of commerce for use or consumption a product or any component part thereof." Tex. Civ. Prac. & Rem. Code § 82.001(3). We presume the Legislature was aware of our case law when it enacted a substantially similar definition **[*15]** of "seller" in the Products Liability Act. In re Allen, 366 S.W.3d 696, 706 (Tex. 2012) ("A statute is presumed to have been enacted by the legislature with complete knowledge of the existing law and with reference to it." (internal quotation marks and citation omitted)). Oddly, by arguing that it is a seller for statutory-indemnity purposes, Centerpoint is essentially conceding that it would be a seller for purposes of a strict-liability claim brought by an injured party.

'manufacturing' or selling such products and therefore does not come within the ambit of [strict products liability]."), *superseded by statute on other grounds*, [Nev. Rev. Stat. § 40.635](), *as recognized in* [Olson v. Richard, 120 Nev. 240, 89 P.3d 31 (Nev. 2009)](); [Scordino v. Hopeman Bros., 662 So. 2d 640, 645 (Miss. 1995)]() (holding that a subcontractor hired to build the interior outfitting of a ship, which included providing the necessary services and materials, was not a "seller" of the wall paneling it provided and installed under the contract); *compare* [State Stove Mfg. Co. v. Hodges, 189 So. 2d 113, 115, 123-24 (Miss. 1966)]() (holding that contractors that installed a water heater as part of their construction of a residence were subject to strict liability because they also operated **[*17]** the hardware store that sold the water heater to the homeowners), *superseded by statute on other grounds*, [Miss. Code Ann. § 11-1-63](), *as recognized in* [Huff v. Shopsmith, Inc., 786 So. 2d 383 (Miss. 2001)]().[6]

We agree with the reasoning of these cases and hold that one is not "engaged in the business of" selling a product if providing that product is incidental to selling services. Applying that standard here requires the conclusion that **[*18]** Centerpoint is not a truss "seller" entitled to seek indemnity from the manufacturer. To that end, whether Centerpoint technically sold trusses to Glenmont does not make it "engaged in the business of" commercially distributing that product.[7] As in *Barham*, any "'sale' of [trusses] by [Centerpoint] was incidental to its contract to provide the services necessary to construct a building."[8] [Barham, 803 S.W.2d at 738](). This is consistent with the way the materials were priced in the contract. Centerpoint did not set prices on the materials to achieve a gain or profit;[9] it was effectively reimbursed for the cost of materials that were necessary to complete construction.[10]

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[6] In classifying general contractors in contexts other than indemnity and strict liability, courts similarly focus on the fact that contractors' businesses involve the rendition of construction services, while "the materials that pass are incidental." [State, Dept. of Revenue v. Debenham Elec. Supply Co., 612 P.2d 1001, 1002-03 (Alaska 1980)]() (holding that contractors were not "dealers" of products for sales tax purposes); [Nixon v. U. S. Fid. & Guar. Co., 290 So. 2d 26, 27-29 (Fla. 1973)]() (holding that "products—completed operations" exclusion in general contractor's liability policy did not preclude coverage and noting the "significance that [the insured] is engaged in the general contracting business; he is not a manufacturer or seller of goods or products"); [Material Serv. Corp. v. McKibbin, 380 Ill. 226, 43 N.E.2d 939, 946 (Ill. 1942)]() ("A contractor holds himself out to the public as having the skill and knowledge necessary to the construction of certain improvements. He does not represent himself as being engaged in the business of selling building material.").

[7] By way of example, consider a hair salon that offers haircuts that include a wash and style. When the client walks out of the salon, she has shorter hair, but she also has a head full of hair product. The price of the haircut will inevitably include the cost of the product that was used. Still, a hairdresser is in the business of selling haircuts, not selling handfuls of mousse. One does not go to the hair salon to acquire a dollop of moisturizing serum and a few spritzes of hairspray, just as a person does not retain a general contractor to acquire **[*19]** trusses.

[8] Centerpoint's standard form contract with Glenmont provided that Centerpoint "shall fully execute the Work described in the Contract Documents." The term "Work" was defined in an ancillary document as "the construction and services required by the Contract Documents, whether completed or partially completed, and includes all other labor, materials, equipment and services provided or to be provided by [Centerpoint] to fulfill [Centerpoint's] obligations. The Work may constitute the whole or a part of the Project." In turn, "Project" is defined as "the total construction of which the Work performed under the Contract Documents may be the whole or a part and which may include construction by [Glenmont] and by separate contractors." Tellingly, the focus of the "Work" and the "Project" is "construction and services," and materials were ancillary to those services. By contrast, Fresh Coat's contract to install EIFS placed "labor, services and/or materials" on equal footing. [Fresh Coat, 318 S.W.3d at 899](). We therefore disagree with the dissent's contention that the two contracts contain no "relevant differences," *post* at __, and, in any event, the contract language is but one consideration in our analysis.

[9] The **[*20]** "Contract Sum," constituting "the total amount payable by the Owner to the Contractor for performance of the Work under the Contract Documents," was a stipulated lump sum subject to certain authorized additions and deductions. That sum included allowances for materials and equipment delivered at the site. If the actual costs were greater or less than the allowances, Centerpoint was to submit a change order.

[10] The dissent dismisses this consideration, citing examples of companies that may be engaged in the business of selling a product

In turn, as the court of appeals noted, "Centerpoint's contract with the property owner covered innumerable construction products and materials that would be involved in the construction of the apartment complex." 436 S.W.3d at 888. And that is the nature of a general contractor's business when it builds based on custom designs and specifications, as the materials **[*21]** required for a particular project will vary. *See* Restatement (Third) of Torts: Prod. Liability § 19 cmt. e (1998) ("A housing contractor, building and selling one house at a time, does not fit the pattern of a mass producer of manufactured products . . . ."). Although the quantity of materials used is not dispositive, we agree with Trussway's contention that "the fact that Centerpoint used innumerable building materials supports the conclusion that any single material was incidental to its provision of construction services."

In sum, we hold that a general contractor who is neither a retailer nor a wholesale distributor of any particular product is not necessarily a "seller" of every material incorporated into its construction projects for statutory-indemnity purposes. Whether a person or entity is "engaged in the business of" selling a service, selling a product, or doing both (as in *Fresh Coat*)—regardless of the person's classification as a general contractor or subcontractor—depends upon the specific facts at issue. In this case, evidence that the general contractor agreed to undertake construction of the entire building and to be reimbursed for the cost of the materials (including the trusses) indicates that Centerpoint was selling construction **[*22]** services rather than trusses or other building materials. While some contractors may engage in the business of selling both products and services, the record is devoid of evidence that Centerpoint was doing so here. Instead, the record shows that any sale of the trusses by Centerpoint "was incidental to its contract to provide the services necessary to construct a building." Barham, 803 S.W.2d at 738. Because Centerpoint was "engaged in the business" of providing a service, and its provision of trusses was incidental to that service, Centerpoint is not a "seller" under the Products Liability Act.[11]

**C**

Finally, we address the dissent's reliance on two cases from this Court that purportedly support the dissent's conclusion that Centerpoint is a seller. Neither of those cases involves contractors, and neither supports the dissent's position.

In *Barbee v. Rogers*, we held **[*23]** that the plaintiff could not pursue a strict-liability claim against licensed optometrists for failing to properly fit prescribed contact lenses to the plaintiff's eyes. 425 S.W.2d 342, 346 (Tex. 1968). We explained that the optometrists' activities "fall between those ordinarily associated with the practice of a profession and those characteristic of a merchandising concern." Id. at 345. In rejecting the strict-liability claim, we noted that in addition to "the disqualifying factor of the professional relationship," the claim was "not premised on any defect in the lenses as such." Id. at 346.

The dissent extrapolates from this statement that, had such a defect been alleged, "the optometrist would have been a 'seller' subject to strict liability even though the sales were incidental to the defendant's optometric

even if they do not seek to profit from the specific sales giving rise to an indemnity claim. *Post* at __. But we are not mandating a profit-seeking motive as a prerequisite to seller status; we are simply identifying the pricing structure in Centerpoint's contract as pertinent to what it is "engaged in the business of" doing.

[11] In reaching the opposite conclusion, the dissent implies that we have "stray[ed] from the plain language of a statute." *Post* at __. Statutes are not always clear, and interpreting them can be a difficult task. That the Court and the dissent disagree on the ultimate interpretation of a statutory provision does not mean that either has "encroach[ed] on the Legislature's function." *Id.* at __.

services." *Post* at __. But *Barbee* simply does not support this assertion. First, what we would have held in the event the plaintiff asserted a hypothetical defective-lens claim is not at all obvious, particularly in light of the professional relationship between the parties. *See* Barbee, 425 S.W.2d at 346. Further, the dissent assumes that product sales in *Barbee* were incidental to services, but we described evidence indicating the opposite, noting the defendants' **[*24]** "advertising and sales techniques designed to promote the sale of contact lenses at a predetermined and advertised price" and "their standardization of procedures and methods."[12] *Id.* We simply did not conduct a "seller" analysis, and the dissent's presumption about the outcome of such an analysis is neither helpful nor justified.

The dissent also cites *New Texas Auto Auction Services, L.P. v. Gomez de Hernandez*, in which we held that an auctioneer who conducted sales of automobiles was not a seller subject to strict liability. *249 S.W.3d 400, 405-06 (Tex. 2008)*. The parties in that case agreed that auctioneers are generally not considered sellers, and disputed only the significance of the fact that the defendant atypically held title to the allegedly defective vehicle when it was sold. *Id. at 405*. We found that fact immaterial, noting that strict liability "applies to those whose *business* is selling, not everyone who makes an occasional sale." *Id.* We agree with this broad proposition; however, our analysis in *New Texas Auto* of whether an auctioneer was a seller is of little help in this factually dissimilar case.

## IV

The Products Liability Act defines "seller" not simply as "a person who **[*25]** sells" or "a person who places a product in the stream of commerce," but as a person "engaged in the business of" commercially distributing products. We may not ignore the Legislature's prudently selected words, lest we stray from the statute's plain language. Centerpoint has not shown that it is "engaged in the business of" commercially distributing or placing trusses in the stream of commerce. Accordingly, Centerpoint is not a "seller" entitled to seek indemnity under chapter 82. We affirm the court of appeals' judgment.

Debra H. Lehrmann

Justice

**OPINION DELIVERED:** June 17, 2016

**Dissent by:** Jeffrey S. Boyd

## Dissent

Centerpoint Builders seeks indemnity from Trussway, Ltd., under the Texas Products Liability Act. The sole issue in this interlocutory appeal is whether Centerpoint qualifies under the Act as a "seller" of Trussway's allegedly defective roof truss. The first time this Court addressed the Act's indemnity provisions it warned that, "when we stray from the plain language of a statute, we risk encroaching on the Legislature's function to decide what the law should be." *Fitzgerald v. Advanced Spine Fixation Systems, Inc., 996 S.W.2d 864, 866 (Tex. 1999)*. I conclude that the Court strays from the statute's plain language in this case by excluding from the definition of "seller" those **[*26]** persons whose sales of a product are "incidental" to its sales of services. *Ante* at __. The statute's definition of "seller" says nothing about sales that are "incidental" to sales of services. Instead, it includes all those who are "engaged in the business of" selling the product, and nothing in the ordinary, common meaning of the phrase "engaged in the business" excludes business activities that are "incidental" to other business activities in which the person is also engaged.

[12] No such evidence was presented in this case.

Because the evidence here establishes that Centerpoint was "engaged in the business of" selling trusses, the Act's plain language makes it a "seller" entitled to indemnity regardless of whether those sales were "incidental" to its other business activities. Because the Court holds otherwise, I respectfully dissent.

**I**.

**Introduction**

Centerpoint was the general contractor for the construction of an apartment complex on property owned by Glenmont Madison Beaumont, LLC. Pursuant to the contract, Centerpoint purchased preassembled roof trusses[1] directly from Trussway, Ltd., and subcontracted with Sandidge & Associates to install them. Sandidge, in turn, contracted with Merced Fernandez to assist with the installation. **[*27]** During the construction, Sandidge's crew moved the trusses into place on top of what would become the second-floor ceiling and left them laying there flat like "fallen dominoes" until they could be raised and installed. While carrying a piece of sheetrock and using the uninstalled trusses like a "platform" above the second floor, Fernandez stepped on one of the trusses, the board beneath him broke, and he fell and suffered permanent, debilitating injuries.

Fernandez sued Glenmont, Centerpoint, Sandidge, and Trussway, alleging that the truss that broke beneath him was unreasonably dangerous and that "the Defendants" (including Centerpoint) "designed, manufactured, marketed, distributed[,] and utilized" the product and "placed [it] into the stream of commerce." Centerpoint and Trussway filed cross-claims against each other seeking indemnity from the other under the Texas Products Liability Act. *Tex. Civ. Prac. & Rem. Code §§ 82.001-.008*. Both Centerpoint and Trussway then filed cross-motions for summary judgment on their indemnity claims.

The trial court denied Trussway's summary-judgment motion and granted partial summary judgment for Centerpoint, holding that, for purposes of indemnity under the Act, Centerpoint was a "seller" of the allegedly defective truss. On Trussway's agreed interlocutory appeal, the court of appeals reversed, and this Court now affirms that court's judgment. In support of its conclusion that Centerpoint was not a seller of the allegedly defective truss, the Court cites to the text of the Products Liability Act, our precedents construing that text, and other precedents that address **[*29]** whether a party is a "seller" under common-law strict-liability principles. In my view, none of these authorities support the Court's conclusion.

**II**.

**The Text**

The Texas Products Liability Act requires a "manufacturer" to "indemnify and hold harmless a seller against loss arising out of a products liability action, except for any loss caused by the seller's negligence, intentional misconduct, or other act or omission, such as negligently modifying or altering the product, for which the seller is independently liable." *Tex. Civ. Prac. & Rem. Code § 82.002(a)*. The parties agree that Trussway was the

[1] According to the parties and the record, trusses are wooden structures typically formed by fastening multiple 2x4 boards together using a particular design that enables them to bear the weight of a roof suspended above the ceiling below. Builders (or their framing subcontractors) sometimes construct trusses themselves by nailing the necessary boards together at the jobsite. Alternatively, the builder may purchase fully constructed trusses from a truss manufacturer like Trussway, and then modify them at the jobsite as necessary, as Centerpoint did here. By suspending the roof above the ceiling, trusses create attic space above the floor below. After the framers install the trusses, a drywall (or "sheetrock") subcontractor may install **[*28]** drywall along the trusses' vertical boards to finish-out the attic space.

"manufacturer" of the allegedly defective truss, that this is a "products-liability action," and that Centerpoint seeks indemnification for a "loss" arising out of this action. The only issue is whether Centerpoint was a "seller" of the allegedly defective truss.

Because the Products Liability Act expressly defines the term "seller," we need not decide in this case whether Centerpoint was a seller of trusses under the term's common, ordinary meaning.[2] When construing a statute, we do not rely on a term's ordinary meaning if a "different meaning is supplied by legislative definition." *Tex. Lottery Comm'n v. First State Bank of DeQueen, 325 S.W.3d 628, 635 (Tex. 2010)*. If the statute defines a term, we are "bound to **[*30]** construe that term by its statutory definition only." *Tex. Dep't of Transp. v. Needham, 82 S.W.3d 314, 318 (Tex. 2002)* (citing *Tex. Gov't Code § 311.011(b)*). The Products Liability Act expressly defines the term "seller" to mean "a person who is engaged in the business of distributing or otherwise placing, for any commercial purpose, in the stream of commerce for use or consumption a product or any component part thereof." *Tex. Civ. Prac. & Rem. Code § 82.001(3)*. We must decide whether Centerpoint is a seller under this definition.

It is undisputed that Centerpoint "distributed"[3] the truss in the stream of commerce[4] for use or consumption, and did so for a commercial purpose. The Court concludes, however, that Centerpoint was not a seller because it was not "*engaged in the business of* commercially distributing" trusses. **[*32]** *Ante* at __ (emphasis added). Because the Act does not define "engaged in the business of," the Court seeks the common ordinary meaning of that phrase in *Black's Dictionary*, which defines

- "engaged" as "to employ or involve oneself," "to take part in," or "to embark on," *ante* at __ (quoting *Engage*, BLACK'S 10th ed.);

- "business" as a "commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain," *ante* at __ (quoting *Business*, BLACK'S 10th ed.); and

- "doing business" as "the carrying out of a series of similar acts for the purpose of realizing a pecuniary benefit," *ante* at __ (quoting *Doing Business*, BLACK'S 10th ed.).

Relying on these dictionary definitions to inform the meaning of the "entire phrase . . .

[2] The Court suggests that the record here is "devoid of evidence" that Centerpoint was a "seller" of trusses, and that the evidence "indicates that Centerpoint was selling construction services rather than trusses or other building materials." *Ante* at __. To the extent the Court means to suggest that there is no evidence that Centerpoint was a truss "seller" under the common, ordinary meaning of that term, I disagree. In ordinary usage, a "seller" is simply someone "who sells or contracts to sell goods," or even more generally, "a person who sells anything; the transferor of property in a contract of sale." *Seller*, BLACK'S LAW DICTIONARY (10th ed. 2014) (hereinafter BLACK'S 10th ed.). Under their standard American Institute of Architects form contract, Centerpoint agreed to complete "the **[*31]** Work," which included the obligation to "provide and pay for" all "materials" necessary to "fulfill [Centerpoint's] obligations." The contract required Centerpoint to warrant to Glenmont that all such materials were "of good quality and new" and "free from defects." In exchange for the Work, Glenmont agreed to pay Centerpoint a lump sum that included amounts to "cover the cost to [Centerpoint] of materials," including materials to be "incorporate[ed] in the completed construction." The contract specified the amount Glenmont would pay for the floor and roof trusses. And the contract expressly provided that all payments for all materials would be conditioned on Glenmont becoming the legal owner of those materials. In short, the parties agreed that Centerpoint would purchase and provide the trusses, Glenmont would pay Centerpoint for the trusses, and Glenmont would then own the trusses. And that is exactly what happened.

[3] To "distribute" means to "deliver," to "spread out; to disperse." *Distribute*, BLACK'S 10th ed.

[4] *See Fresh Coat, Inc. v. K-2, Inc., 318 S.W.3d 893, 899 (Tex. 2010)* (rejecting argument that contractor "did not place [stucco product] into the stream of commerce since [the product] was applied to walls that were part of newly constructed homes").

'engaged in the business of,'" the Court holds that "one is not 'engaged in the business of' selling a product if providing that product **[*33]** is *incidental* to selling services." *Ante* at __ (emphasis added). Applying that holding, the Court concludes that Centerpoint's sales of trusses were "incidental to its contract to provide the services necessary to construct a building," *ante* at __(quoting [Barham v. Turner Constr. Co. of Tex., 803 S.W.2d 731, 738 (Tex. App.—Dallas 1990, writ denied))](), because "Centerpoint did not set prices on the materials to achieve a gain or profit," *ante* at __, and "Centerpoint used innumerable building materials" in addition to the trusses, *ante* at __. The Court then goes on to hold that "a general contractor who is neither a retailer nor a wholesale distributor of any particular product is not necessarily a 'seller' of every material incorporated into its construction projects . . . ." *Ante* at __. I disagree, because nothing in the statute's definition of "seller" or in the common meaning of "engaged in the business of" supports the Court's two holdings or the evidentiary factors on which it relies.

### A. First Holding: "Incidental" Sales

The Court's first holding is that "one is not 'engaged in the business of' selling a product if providing that product is *incidental* to selling services." *Ante* at __ (emphasis added). Although the Court does not explain what it means by "incidental," **[*34]** that term commonly refers to something "[s]ubordinate to something of greater importance" or having "a minor role" within a greater enterprise. *Incidental*, BLACK'S 10th ed. Presumably, under the Court's incidental-sales test, an entity is not "engaged in the business of" selling a product if that business activity is "subordinate" in importance to, or plays only a "minor role" compared with, other business activities in which the entity is also engaged. Nothing in the common meaning of "engaged in the business" or in the statutory definition of "seller" supports this test.

An entity can of course be simultaneously engaged in more than one business activity,[5] and one or more of those activities will likely be more important or primary to the entity or to a particular transaction than another. Similarly, the entity may engage more regularly or continuously in one or more business activities than another. But that one business activity is less important or primary or that the entity engages in it less regularly or frequently does not mean it is not "engaged in the business of" that activity. Under the common, ordinary meaning, the entity is still "engaged in" (i.e., "employed," or "involved" or "taking **[*35]** part" in, *see Engage*, BLACK'S 10th ed.) that "business" (i.e., the "commercial enterprise carried on for profit" or "gain," *Business*, BLACK'S 10th ed.), as those terms are commonly understood.

Numerous Texas statutes confirm that the common meaning of "engaged in the business of" does not exclude activities that are "incidental" to a business's other activities.[6] Many statutes, for example, expressly apply only to persons that are "primarily" or "principally" engaged in the business of a particular activity.[7] And many other statutes

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[5] *See, e.g.*, [Gregory v. Roedenbeck, 141 Tex. 543, 174 S.W.2d 585, 587 (Tex. 1943)]() (noting that persons engaged in the oil-and-gas-well-supply business may also be "engaged in other business"); [Hous. Life Ins. Co. v. Dabbs, 132 Tex. 566, 125 S.W.2d 1041, 1043-44 (Tex. 1939)]() (noting that a corporation can "engage[] in a business foreign to its charter powers").

[6] This Court regularly and properly relies on "the use and definitions of [a] word in other statutes" to determine the word's **[*36]** common, ordinary meaning. [Jaster v. Comet II Constr., Inc., 438 S.W.3d 556, 563 (Tex. 2014)]() (plurality op.).

[7] *See, e.g.*, [Tex. Civ. Prac. & Rem. Code § 27.010(b)]() (providing that the Texas Citizens Participation Act does not apply to certain legal actions against "a person *primarily* engaged in the business of selling or leasing goods or services" (emphasis added)); [Tex. Gov't. Code § 27.060(c)(2)]() (requiring that Supreme Court adopt justice-court rules for "specific procedures for an action by a person *primarily* engaged

expressly apply only to those who "continuously" or "regularly" engage in a particular business activity or that conduct at least a certain minimum amount or volume of the business.[8] In fact, some statutes expressly apply only to entities that are *both* primarily or principally *and* regularly engaged in a particular business activity.[9]

As the Court itself explains, we must presume that "the Legislature deliberately and purposefully selects words and phrases it enacts, as well as deliberately and purposefully omits words and phrases it does not enact." *Ante* at __ quoting *Tex. Mut. Ins. Co. v. Ruttiger, 381 S.W.3d 430, 452 (Tex. 2012))*. The fact that many statutes include words that limit the scope **[*38]** of the phrase "engaged in the business of" indicates that statutes that omit those words are not so limited. If, as the Court asserts, the common meaning of "engaged in the business of" does not include business activities that are only "incidental" to the business or transaction, there would be no need to limit statutes to those who are "primarily" or "principally" engaged in a particular business, or who engage in the business "regularly" or "continuously." Under the Court's construction, a statute that applies to entities that are "engaged in the business of" a particular activity already excludes those that only "incidentally" engage in that activity. If that were true, there would be no need for statutes to modify the phrase "engaged in the business" with terms like "primarily," "principally," or "regularly," and those terms would be meaningless and superfluous in all the statutes that use them. Of course, we must not construe statutes in ways that render statutory terms "meaningless or superfluous." *Columbia Med. Ctr. of Las Colinas, Inc. v. Hogue, 271 S.W.3d 238, 256 (Tex. 2008)*.

I believe we must acknowledge and respect the fact that the Products Liability Act's definition of "seller" includes all those "engaged in the business" of selling a product, and **[*39]** does not employ limiting words like "primarily" or "regularly" or, as the Court holds today, "non-incidentally." The Products Liability Act thus applies to all persons "engaged in the business" of selling a product regardless of whether their engagement in that business is a primary, regular, or merely incidental activity. By construing "engaged in the business" to exclude those whose relevant activities are incidental to other business activities, the Court construes the Act's definition of "seller" as if it included terms like "primary," "principally," and "regularly" when it does not. Of course, we must not do this when construing a statute either. *City of Rockwall v. Hughes, 246 S.W.3d 621, 631 (Tex. 2008)* ("[C]hanging the meaning

in the business of lending money at interest" (emphasis added)); *Tex. Occ. Code § 1052.003(a)(12)* (authorizing a person who "is *primarily* engaged in the business of park and recreation planning" to engage in the practice of landscape architecture (emphasis added)); *Tex. Transp. Code § 396.001(4)* (defining "Recycling business" as a "business *primarily* engaged" in specific activities (emphasis added)); *Tex. Tax Code §§ 171.1011(g-8)*, *(g-10)*, *(g-11)*, *(w-1)* (imposing unique tax obligations on taxable entities that are "*primarily* engaged in" particular businesses (emphasis added)).

[8] *See, e.g.*, *Tex. Elec. Code § 253.103(a)(1)* (prohibiting a corporation from making a loan to a candidate, officeholder, or political committee for campaign or officeholder purposes unless "the corporation has been legally and *continuously* engaged in the business of lending money *for at least one year* before the loan is made" (emphases added)); *Tex. Fin. Code § 308.001* (applying chapter only to **[*37]** persons "*regularly* engaged in the business of extending credit . . . primarily for personal, family, or household use" (emphasis added)); *Tex. Occup. Code § 2352.001(3)* (defining "Dealer" as "a person engaged in the business of buying, selling, . . . or exchanging at least five vessels, motorboats, or boat motors during a calendar year"); *Tex. Parks & Wild. Code § 31.003(7)* (defining "Dealer" as "a person engaged in the business of buying, selling, . . . or exchanging at least five vessels, motorboats, or outboard motors during a calendar year").

[9] *See, e.g.*, *Tex. Fin. Code § 345.001(1)(C)* (defining "credit card issuer" to exclude a person who is "*regularly* and *principally* engaged in the business of lending money for personal, family, or household purposes" (emphases added)); *Tex. Water Code § 26.342(7)(E)* (defining "lender" to include entities that are "*regularly* engaged in the business of extending credit and if extending credit represents the *majority* of the entity's total business activity" (emphases added)).

of the statute by adding words to it, we believe, is a legislative function, not a judicial function.").

Under the ordinary, common meaning of "engaged in the business" and the Act's language, a person is a "seller" under the Products Liability Act if the person is employed or involved (that is, "engaged") in a commercial enterprise for profit or gain (that is, a "business") in which the person distributes or places for use or consumption a product or component part into the stream of commerce for any commercial purpose. **[*40]** *See* *Tex. Civ. Prac. & Rem. Code § 82.001(3)*; *Engage*, *Business*, *Doing Business*, BLACK'S 10th ed. Because the Act's definition of "seller" does not include additional language like "primarily," "principally," "regularly," or "non-incidentally," the question of whether the entity's distribution or placement of the product is "incidental" in comparison to its other business activities is irrelevant to determining whether it is "engaged in the business" at issue.

### B. Second Holding: Contractors and Construction Projects

The Court's second, more specific holding is that "a general contractor who is neither a retailer nor a wholesale distributor of any particular product is not necessarily a 'seller' of every material incorporated into its construction projects . . . ." *Ante* at __. While I agree with this holding as worded, it merely begs the question of when a general contractor is or is not a "seller" of a product it incorporates into a construction project. Under the Products Liability Act's plain language, the answer is that a general contractor *is* a "seller" of a product if it is "engaged in the business of distributing or otherwise placing" the product "in the stream of commerce for use or consumption," and does so "for *any* ***[*41]*** commercial purpose." *Tex. Civ. Prac. & Rem. Code § 82.001(3)* (emphasis added).

To the extent the Court suggests by this holding that the Act's definition of "seller" applies differently to a "general contractor" than to others who sell products, I disagree. The statutory definition includes every "person" who is "engaged in the business," *Tex. Civ. Prac. & Rem. Code § 82.001(3)*, and the Court makes no effort to explain how the Act distinguishes general contractors from any other "person." Nothing in the Act or in the common meaning of "engaged in the business of" imposes different criteria on "general contractors" than on builders, subcontractors, retailers, or wholesalers, and nothing in the common meaning or the Act conditions "seller" status on how the product is ultimately used.

To the contrary, as discussed further below, this Court has held that the fact that the entity is a contractor that provides services through which it incorporates the product into a construction project does not preclude it from being a "seller" of that product. *Fresh Coat, 318 S.W.3d at 899*. Under the Act's language, any "person" (thus, any general contractor, subcontractor, retailer, wholesaler, etc.) "who is engaged in the business of distributing or otherwise placing, for *any* commercial purpose, in the stream **[*42]** of commerce for use or consumption a product or any component part thereof" is a seller, regardless of how the product is used. *Tex. Civ. Prac. & Rem. Code § 82.001(3)* (emphasis added).

### C. Evidentiary Factors

The Court identifies two facts that it believes demonstrate that Centerpoint's placement of trusses into the stream of commerce for commercial purposes was merely "incidental" to its primary business obligations: (1) Centerpoint did not price the trusses to achieve a gain or profit, *ante* at __, and (2) trusses were just one of "innumerable" products that Centerpoint sold, *ante* at __. In my view, because the Act does not support the Court's incidental-sales test, these factors (which the Act never mentions) are irrelevant to the question of whether Centerpoint was a "seller" under the Act. And to the extent they are relevant at all, they merely demonstrate that the common, ordinary meaning of the phrase "engaged in the business of" does not support the Court's new incidental-sales test.

Regarding the Court's first factor, nothing in the Act or the ordinary meaning of "engaged in the business of" requires that the sale of the specific product at issue must be designed to achieve a financial "gain" or "profit." Under the **[*43]** common, ordinary meaning of the phrase, even a non-profit corporation like the Salvation Army may be "engaged in the business" of selling products, even though it is not seeking to "achieve a profit" from those sales. *See, e.g.*, [City of San Antonio v. Salvation Army, 127 S.W. 860, 862 (Tex. Civ. App.—San Antonio 1910, writ ref'd)] (noting the Salvation Army's legislative charter provides that the "proceeds of *said business* shall be devoted to the religious, charitable, educational or missionary purposes of the Salvation Army" (emphasis added)). The statutory definition provides no basis for excluding a non-profit or not-for-profit organization from the Act's indemnity provisions.

More specifically, neither the Act nor the common meaning support the Court's suggestion that a party is "engaged in the business of" selling a particular product only if it seeks a "gain or profit" from the sales of *that specific product*. If a hardware store, for example, decides to sell all hammers for a price below the company's costs, it is still "engaged in the business of" selling those hammers. When cell-phone carriers sold iPhones below cost to attract customers into service contracts, they were still "engaged in the business of" selling iPhones, even if their primary business was providing cellular **[*44]** *services* and they realized no financial gain from the sales of the phones. *See* Matt Scully & Scott Moritz, *iPhones go from T-Mobile Loss Leader to New Source of Cash*, BLOOMBERG (Apr. 30, 2015, 6:07 PM), [http://www.bloomberg.com/news/articles/2015-04-30/t-mobile-changes-iphones-from-loss-leaders-to-source-of-finance] . And when Wal-Mart sold gasoline as a loss-leader in an effort to attract shoppers into their stores, it was still "engaged in the business of" selling gasoline, even if it did not seek a profit or realize a gain from those sales. *See* Brad Tuttle, *Walmart's New Loss Leader: Cheap Gas*, TIME, (June 29, 2011), [http://business.time.com/2011/06/29/walmarts-new-loss-leader-cheap-gas] . In the same way, when Centerpoint sells trusses or other building materials at cost in connection with a contract to build an apartment complex, it is still "engaged in the business of" selling those building materials. Even under the dictionary definitions on which the Court relies, the seller need only be seeking some "gain" or "pecuniary benefit" from the transaction as a whole to be "engaged in the business," even if it may not seek or "achieve a gain or profit" from the specific sale at issue.

Regarding the Court's second factor—that trusses were only one of "innumerable" products that Centerpoint sold—nothing in the Act supports the Court's reliance on this factor either. **[*45]** The Act's definition of "seller" expressly includes a person who distributes a product "for *any* commercial purpose." [Tex. Civ. Prac. & Rem. Code § 82.001(3)] (emphasis added). If a quick-lube shop whose primary business is to offer oil-change *services* sells oil, oil additives, oil filters, fuel filters, air filters, windshield-wiper blades, and "innumerable" other products, the shop is "engaged in the business" of selling each of those products, even if those sales are "incidental" to its oil-change *services* and even if those services are its "primary responsibility" to its customer. If the purpose of the sale is to provide the product in connection with the party's services, the party still distributes the product for a "commercial purpose," and the Act expressly provides that *any* commercial purpose qualifies. *See id.* If a Jiffy Lube only occasionally sells a wiper blade, a hardware store sells only a few auger bits, an AT&T store sells only a few screen protectors, or a Wal-Mart store only occasionally sells a Hula Hoop, they are still "engaged in the business" of selling those products, even if the products are only one of "innumerable" other products that each of them sells.

The apartment project Centerpoint was constructing **[*46]** when Fernandez was injured was one of "four or five" similar construction projects that Centerpoint had going at the time. And as the Court itself acknowledges, it "is the nature of a general contractor's business when it builds based on custom designs and specifications" to provide "innumerable construction products and materials." *Ante* at __. Under the ordinary meaning of "engaged in the business," selling trusses and other building materials is part of the business in which Centerpoint engaged, even if it is an "incidental," and not the "primary," part. Although Centerpoint may be only "incidentally"—and not "primarily" or "regularly"—engaged in the business of selling trusses, it is nevertheless "engaged in the business" of selling trusses. I would apply the unambiguous statutory language and conclude that Centerpoint is a "seller" of trusses under the Products Liability Act. *Tex. Civ. Prac. & Rem. Code § 82.001(3)*.

**III.**

## Chapter 82 Precedent

In addition to its purported reliance on the statutory text, the Court relies on our precedent addressing the Products Liability Act to support its conclusion that Centerpoint does not qualify as a "seller." Although we have addressed the Act's definition of "seller" on a number of **[*47]** occasions,[10] the key precedent here, the one on which both parties rely most heavily, and the one the Court addresses, is *Fresh Coat, 318 S.W.3d 893*. We held in *Fresh Coat* that a construction contractor that installed synthetic stucco products on the exterior walls of new-build homes *did* qualify as a "seller" of those products even though it purchased the products from the manufacturer and provided all the labor and services to install the products on the homes. *Id. at 899*. Noting that the Act "anticipates that a product seller may also provide services," we concluded that "installation services do not preclude [a company] from also being a seller." *Id.*

The Court claims that *Fresh Coat* is unhelpful

[10] The Court first addressed the Act's definition of "seller" in *Fitzgerald. 996 S.W.2d at 867*. In that case, the party seeking indemnity sold the manufacturer's product but not the specific product that allegedly harmed the plaintiffs and was thus dismissed from the suit. *Id. at 865*. Contesting any indemnity obligation, the manufacturer argued that, to qualify as a "seller," the party had to be in the "chain of distribution" of the specific allegedly defective product. *Id.* We disagreed, noting that the Act "does not explicitly require that the seller be proven to have been in the chain of distribution." *Id. at 867*. We rejected **[*48]** the manufacturer's interpretation because it "would have us judicially amend the statute to add an exception not implicitly contained in the language of the statute." *Id.* We laid the proper foundation for interpreting and applying the Act by noting that only "truly extraordinary circumstances showing unmistakable legislative intent should divert us from enforcing the statute as written." *Id.*

More recently, we acknowledged that the Act imposes "'a new, distinct statutory duty' of indemnification because it is, by its terms, 'in addition to any duty to indemnify established by law, contract, or otherwise.'" *Gen. Motors Corp. v. Hudiburg Chevrolet, Inc., 199 S.W.3d 249, 255 (Tex. 2006)* (footnote omitted) (first quoting *Fitzgerald, 996 S.W.2d at 866*; then quoting *Tex. Civ. Prac. & Rem. Code § 82.002(e)(2)*). We thus acknowledged that our preconceptions based on common law liabilities and indemnity cannot control our construction of the Act's provisions. *See id. at 255-57*. And most recently, we recognized that the Act "*broadly* defines [the term] 'seller.'" *Petroleum Sols., Inc. v. Head, 454 S.W.3d 482, 491 (Tex. 2014)* (emphasis added).

here because the "contractor at issue in *Fresh Coat* sold and installed a particular product" while Centerpoint was "a general contractor constructing an improvement to real property." *Ante* at __. I find the Court's attempt to distinguish **[*49]** *Fresh Coat* to be both incomplete and unconvincing. The Court begins by noting that the contract in *Fresh Coat* "required Fresh Coat to provide 'labor, services and/or materials, equipment, transportation, or facilities' necessary to apply and finish the synthetic stucco." *Ante* at __ (citing *Fresh Coat, 318 S.W.3d at 899*). Under the Court's analysis in *Fresh Coat*, however, there are no relevant differences between Fresh Coat's contractual obligations and Centerpoint's (to provide "the construction and services required by the Contract Documents," including "all other labor, materials, equipment and services" necessary "to fulfill its obligations").

Although the Court suggests today that the Fresh Coat contract placed those products on "equal footing" with the services while Centerpoint's contract did not, *ante* at n.8, the Court placed no value on that point in *Fresh Coat*. In both cases, the contract required the party to provide both the allegedly defective "materials" and the services to properly install them in the construction project. Nothing in *Fresh Coat* suggests that the fact that Centerpoint contractually agreed to provide other materials and services requires a conclusion that it was not "engaged in the **[*50]** business" of providing the materials that were later alleged to be defective. Nor does anything in the Act support that proposition.

Next, the Court notes that "Fresh Coat purchased [the synthetic stucco products] from their manufacturer and installed them pursuant to its contract with the builder." *Ante* at __ (citing *Fresh Coat, 318 S.W.3d at 895*). But the Court makes no effort to explain how Fresh Coat's installation of the stucco products pursuant to its contract with the builder is different from Centerpoint's installation of the trusses pursuant to its contract with Glenmont. *See ante* at __. The product at issue in *Fresh Coat* was a combination of component products that the installer had to properly combine, apply, and finish in a particular way at the time of installation. *See Fresh Coat, 318 S.W.3d at 899* (explaining that the synthetic stucco system included a "base coat, mesh, and finish coat"). Here, by contrast, Centerpoint did not rely on Trussway's instructions to "completely or partially assemble" the trusses because Trussway provided the trusses fully assembled. All Centerpoint had to do was install the trusses, and as even Trussway admits, "no builder needs instructions on putting up a truss any more than it needs to be told **[*51]** how to drive a nail." In short, Fresh Coat's sale of the stucco products was far more "incidental" to the services Fresh Coat provided to install the stucco products than Centerpoint's sale of the truss was to the services it provided to install the truss.

Next, the Court states, "In holding that Fresh Coat was a seller, we relied in part on witness testimony that the company was 'in the business of providing [the] products combined with the service of [the] installation.'" *Ante* at __ (quoting *Fresh Coat, 318 S.W.3d at 899*). While the Court correctly quotes from the *Fresh Coat* opinion, the Court did not find such conclusory testimony determinative in *Fresh Coat*, nor could it have. *See, e.g.*, *Elizondo v. Krist, 415 S.W.3d 259, 264 (Tex. 2013)* (rejecting testimony that legal malpractice resulted in reduced settlement as conclusory and mere *ipse dixit*); *Nat. Gas Pipeline Co. of Am. v. Justiss, 397 S.W.3d 150, 161 (Tex. 2012)* (rejecting property owner's valuation testimony as conclusory and speculative). While the testimony may have been worth noting, it was meaningless in the absence of evidence supporting that conclusory assertion. Here, the evidence established that Centerpoint was engaged in the business of selling trusses even if no witness expressly stated that it was.

Finally, the Court simply concludes that, in *Fresh Coat*, "we **[*52]** were not required to consider how and if the analysis would be affected when the person seeking seller status were a general contractor constructing an improvement to real property." *Ante* at __. But Fresh Coat was also a contractor constructing an improvement to real property, and nothing in the Act's definition of "seller" or in our opinion in *Fresh Coat* supports the Court's conclusion that general contractors should be treated differently from any other contractor, person, or entity.

The Court's discussion of *Fresh Coat* is unconvincing, but what the Court does not say about *Fresh Coat* is even more illuminating. The Court makes no effort to distinguish or analogize *Fresh Coat* in light of the incidental-sales test it adopts and applies today. That is because the Court did not apply any incidental-sales test when it applied the Act's plain language in *Fresh Coat*. The *Fresh Coat* Court never considered whether the contractor's obligation to provide the product was "primary" or "incidental," never discussed whether the contractor derived its "profits" or "gains" from its products sales or its installation services or both, and never mentioned whether the contractor sold products other **[*53]** than those alleged to be defective. *See* Fresh Coat, 318 S.W.3d at 899. Those questions, which the Court finds determinative in today's case, do not appear in the Act and thus were simply not relevant to the Court's conclusion that Fresh Coat qualified as a "seller."

Instead, when the *Fresh Coat* Court addressed the specific question of whether the contractor could be a "seller," it expressly agreed with the court of appeals' holding in that case that the Act's "definition of 'seller' does not exclude a seller who is also a service provider, nor does it require the seller to only sell the product." *Id. at 899* (quoting *K-2, Inc. v. Fresh Coat, Inc., 253 S.W.3d 386, 393 (Tex. App.—Beaumont 2008))*. And it specifically recognized that "homebuilders and their contractors" could seek indemnity as sellers under the Act. *Id. at 898-99*. Ultimately, the Court agrees with Trussway's argument that, under *Fresh Coat*, Centerpoint could not be a truss seller because it sold "'construction services,' not building materials." *Ante* at __. But it does not explain why it believes that is an either/or proposition, as if Centerpoint's status as a construction-services seller precludes it from also being a truss seller. The Court expressly rejected this very approach in *Fresh Coat*, holding that "the company's installation services do **[*54]** not preclude it from also being a seller." *Fresh Coat, 318 S.W.3d at 899*. Applying that holding here, Centerpoint, like Fresh Coat, was "engaged in the business" of distributing the trusses it undeniably sold, and is therefore a "seller" under the Act even though it also provided services.

## IV.

### Strict-Liability Cases

Ultimately, the Court relies not on our own applicable decision in *Fresh Coat* but on other courts' decisions addressing the issue of whether a service provider is a "seller" of products under common-law strict-liability principles. This case, however, presents the issue of who is a seller under the Products Liability Act, not who is a seller under common-law strict-liability principles. I believe it is unnecessary and imprudent to address the difficult and complicated common-law issue that this case does not raise.

The common-law principle and the Act's indemnity provisions address two separate but related issues. Under the common law, "the seller of a defective product is subject to strict liability for damages the product causes even though the defect was not his fault, but he is generally entitled to indemnity from the manufacturer by statute and by common law." *SSP Partners v. Gladstrong Invs. (USA) Corp., 275 S.W.3d 444, 446-47 (Tex. 2009)* (footnote omitted). The cases on which **[*55]** the Court relies address whether and when a party that provides or distributes a product in connection with its service is considered to be a "seller" that is strictly liable for any defect in the product under the common law. This is an issue that has been the subject of extensive discussion and debate throughout the country for many years. *See, e.g.*, William C. Powers, Jr., *Distinguishing Between Products and Services in Strict Liability*, *62 N.C. L. REV. 415 (1984)*.[11]

As the Court notes, other courts have held, at least generally, that a service provider that also distributes products is not a "seller" subject to **[*57]** strict liability under the common law if:

- the sale of the product was only "incidental" to the service contract and the provider only "occasional[ly]" sold the products at issue, *Barham, 803 S.W.2d at 738*;

- the provider does not place the product in the stream of commerce, *Peterson Homebuilders, Inc. v. Timmons, No. 14-03-00400-CV, 2004 Tex. App. LEXIS 6765, 2004 WL 1660936, at *5 (Tex. App.—Houston [1st Dist.] July 27, 2004, no pet.)* (mem. op.) (concluding without discussion that a subcontractor who built a foundation pad for a house "did not place this structural pad in the stream of commerce");

- the provider simply "used" the product when constructing a project, *Maack v. Res. Design & Constr., Inc., 875 P.2d 570, 581 (Utah Ct. App. 1994)* (holding that a subcontractor was not a seller because it "simply utilized these component parts when constructing the residence—they were not in the business of selling stucco, adhesives, or membranes on a wholesale or retail basis"); or

- the product becomes an integral part of the building being constructed, *Calloway v. City of Reno, 116 Nev. 250, 993 P.2d 1259, 1272 & n.5 (Nev. 2000)* (holding that a contractor who merely installs products as part of a construction project "is not engaged in the business" of selling the products and therefore not a seller subject to strict liability).

We rejected some of these very reasons in *Fresh Coat* when we specifically held that the Act does not exclude those that provide construction services from being a "seller," even when the product is used in and incorporated **[*58]** into a building project.

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[11] In his article published more than thirty years ago, President Powers explained that one rationale for imposing strict liability is the recognition that plaintiffs often lack access to the evidence necessary to prove the facts that would allow them to recover under fault-based liability theories. *Id.* Powers proposed that courts should decide whether the defendant in a "hybrid product-service case[]" is a "seller" subject to strict liability by inquiring "whether it is the type of case that evokes the proof rationale of strict products liability." *Id. at 430*. In his view, many transactions that involve the provision of both products and services "can be classified themselves fairly easily as product or service" based on the proof rationale. *Id. at 431*. If a plumber **[*56]** who installs a water heater is sued, for example, a claim asserting "defective installation might be considered a service, since [the installation] occurred at a location accessible to the consumer after he had selected the plumber." *Id. at 430*. A claim asserting a "defect in the water heater, however, would subject the consumer to the obstacles of proof that make product injuries special, and might therefore be governed by strict liability," so "the plumber would be treated like a [seller] of a defective product." *Id.* Even in cases that involve "homogeneous transactions" implicating both a product and a service, he suggested "a court might distinguish between causes of an injury that are local and contemporaneous (such as failure to rectify a sagging transmission line) and those that are remote and ancient (such as engineering studies concerning the location of water wells)." *Id. at 432*. In his view, "the proof rationale at least provides courts with a co-herent, workable method of analyzing cases that are on the border between products and services." *Id.*

Fresh Coat, 318 S.W.3d at 899. Instead of relying on those extra-jurisdictional cases, I find better guidance in this Court's own decisions.

First, in Barbee v. Rogers, 425 S.W.2d 342, 346 & n.3 (Tex. 1968), the Court addressed whether an optometrist was a "seller" of contact lenses subject to strict liability under the common law. In answering that question, the Court focused on the plaintiff's allegations to determine whether he alleged that his injuries resulted from defective optometry services or a defective product. Id. at 346. The Court concluded that the optometrist could not be strictly liable as a seller because the plaintiff in that case attributed the injury not "to the product itself, i.e., the contact lenses, but to the professional and statutorily authorized act of 'measuring the powers of vision' of [the plaintiff's] eyes and 'fitting lenses . . . to correct or remedy . . . (his) defect or abnormal condition of vision.'" *Id.* (alterations in original). In short, the alleged "miscarriage, if such there was, rests in the professional acts of Respondents and not in the commodity they prescribed, fitted[,] and sold." *Id.* Because the plaintiff complained not of "the act of one selling a 'product in a defective condition unreasonably dangerous **[*59]** to the user,'" but instead complained of "the act of one deemed in law to have the competence to remedy a visual defect by furnishing particularly prescribed contact lenses," the Court concluded that the optometrist was not a seller subject to strict liability in that case. *Id.* Under the Court's reasoning in *Barbee*, if the plaintiff had alleged that the contact lenses were defective, rather than the optometrist's services, the optometrist would have been a "seller" subject to strict liability even though the sales were incidental to the defendant's optometric services.[12]

Second, our more recent decision in New Texas Auto Auction Services, L.P. v. Gomez de Hernandez, 249 S.W.3d 400 (Tex. 2008), confirms that a party whose business involves transferring ownership of a product from itself to another party is a "seller" subject to strict liability under the common law. Id. at 404. The issue in *New Texas Auto* was whether an auctioneer that facilitated the sale of an allegedly defective **[*62]** automobile was a seller subject to strict liability under the common law. 249 S.W.3d at 401-02. In holding that the auctioneer was not such a seller, the

[12] The Court rejects *Barbee* as authority because the Court did not expressly state in that case that the optometrist would have been a seller if the plaintiff had asserted product-liability claims against the optometrist, and because the Court "simply did not conduct" the incidental-sales analysis that it adopts and applies today. *Ante* at __. The relevance of *Barbee*, however, is exactly that: in a common-law strict-liability context, the Court did *not* apply the incidental-sales test the Court applies today, but focused instead on the plaintiff's allegations against the optometrist. Barbee, 425 S.W.2d at 346. Similar to the approach President Powers **[*60]** advocated, *see supra* note, the Court noted that the optometrist's business involved both the provision of optometry services and "a merchandising concern," Barbee, 425 S.W.2d at 345, and concluded that the optometrist was not a seller subject to strict liability in that particular case because the alleged liability was "not premised on any defect in the lenses as such" but on the services the optometrist provided, id. at 346.

As the following discussion of the Restatement's principles explains, this "proof rationale," based on the nature of the plaintiff's allegations against the party seeking indemnity, may answer the Court's illustration regarding hair salons and products. *See ante* at n.7. While the Court apparently doubts that we would hold that a hair stylist can be strictly liability as a seller of the products used when providing hair-styling services, our decision in *Barbee*, President Powers' proof rationale, and the Restatement all suggest that the law should hold the stylist liable *if*, for example, the customer alleges that the product was defectively designed or manufactured and damaged her hair or scalp. On the other hand, if the customer alleges that the product was defective because the stylist improperly **[*61]** used or applied it, these authorities suggest that we should not subject the stylist to strict liability as the product's seller. However we might decide that issue, the Court's illustration demonstrates why the Court should not rely on common-law strict-liability cases from other courts and jurisdictions to decide whether Centerpoint is a seller under the Products Liability Act, because for these purposes the Legislature has already decided that issue. The day may come when we must reconsider *Barbee*'s approach to deciding whether a service provider is subject to common-law strict liability as a seller of products provided in connection with its services. This, however, is not that day. As for whether the hair stylist would be a seller entitled to statutory indemnity under the Products Liability Act, we must at least agree that only the Act itself must provide the answer.

Court noted that businesses that "*play only an incidental role* in a product's placement" (as opposed to the Court's holding that businesses that only engage in "incidental" sales of the product) are not sellers, and that strict liability "applies to those whose *business* is selling, not everyone who makes an occasional sale." *Id.* (first emphasis added). We reached that conclusion, however, not because auctioneers are not "engaged in the business" of selling, but because auctioneers generally do not sell at all. *Id. at 404-05*. "Auctioneers are usually neither buyers nor sellers, but agents for both." *Id. at 401*. Although "they are obviously engaged in sales," we explained, "the *only* thing they sell for their own account is their services; the items they auction are generally sold for others." *Id. at 402* (emphasis added). The distinction we recognized in *New Texas Auto* between a "seller" and an auctioneer was in the fact that auctioneers are not "engaged in the business of *selling* or otherwise *distributing* products" because an auctioneer neither "transfers ownership" nor "provides the **[*63]** product." *Id. at 404* (quoting *RESTATEMENT (THIRD) OF TORTS § 1* (AM. LAW. INST. 1998)). A seller, in other words, is one who passes title from itself to another, not one who assists with or facilities such a transaction for another. *Id. at 404-05*.

Once the Court identified that distinction in *New Texas Auto*, it then noted that the auctioneer in that case had in fact "actually held title to the [allegedly defective automobile] when it was finally sold at auction." *Id. at 405*. Thus, that auctioneer was in fact the "seller" in that particular transaction. *See id.* But "it was undisputed that [the auctioneer] normally never took title to the cars it auctioned, and did so here only because an arbitrator ordered it to do so." *Id.* Because sellers subject to strict liability are "those whose *business* is selling, not everyone who makes an occasional sale," the Court concluded that the auctioneer in that case was not subject to strict liability even though it actually sold the vehicle in that case. *Id. at 405-06*. The Court reached that conclusion not because the sale in that case was only "incidental" to the auctioneer's services, but because the auctioneer "normally never" engaged in such sales at all. *Id. at 404-05*.

In discussing these principles in *New Texas Auto* ***[*64]*** , the Court relied heavily on the Restatement (Third) of Torts. The Restatement supports the proposition that a service provider that also distributes products can be a "seller" subject to strict liability under the common law. It begins with the unremarkable principle: "Services, even when provided commercially, are not products." *RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 19* (1998). But it rejects the notion that one who provides a service is not a seller of products used in the provision of the service. To the contrary, the Restatement explains, "When a building contractor sells a building that contains a variety of appliances or other manufactured equipment, the builder, together with the equipment manufacturer and other distributors, are held as product sellers with respect to such equipment notwithstanding the fact that the built-in equipment may have become, for other legal purposes, attachments to and thus part of the underlying real property." *Id. § 19 cmt. e*.

Thus, for example, "one who contracts to inspect, repair, and maintain machinery owned and operated by another is the provider of a product-related service rather than the provider of a product." *Id. § 19 cmt. f*. However, if "a product repairer replaces a worn-out component part with **[*65]** a new part, the replacement constitutes a sale of the part . . . ." *Id.* And one "sells or otherwise distributes a product when, in a commercial transaction, one provides a combination of products and services and either the transaction taken as a whole, or the product component thereof," constitutes a commercial sale or distribution of the product. *Id. § 20(c)*. When a service-provider sells or provides a product that is "consumed or permanently transferred to the customer" in connection with the service, "the transaction ordinarily is treated as a sale of the material that is consumed in providing the service," and this is true "[e]ven when the service provider does not charge the customer separately" for the product. *Id.* *§ 20 cmt. d*. In short, as we noted in *Fresh Coat*, the Restatement "recognizes that a product seller may also provide services." *318 S.W.3d at 899*.

Ultimately, however, the Court need not and should not decide in this case whether Centerpoint was a "seller" subject to strict liability under the common law. The issue before us is whether Centerpoint is a "seller" who is entitled to indemnity under the Products Liability Act. The Court appears to equate the two today. *See ante* at n.5 (suggesting that **[*66]** "by arguing that it is a seller for statutory-indemnity purposes, Centerpoint is essentially conceding that it would be a seller for purposes of a strict-liability claim brought by an injured party"). As we noted in *New Texas Auto*, however, the Products Liability Act "was not intended to replace [the Restatement] or the common law except in limited circumstances[, and] its broad definitions were drafted to provide indemnity for all retailers, even if they are not proper defendants in an underlying products claim." *249 S.W.3d at 405* (citing *Fitzgerald, 996 S.W.2d at 867* (holding defendant who did not sell product that injured plaintiff was nevertheless entitled to indemnity)).

For these reasons, the Court's reliance on other courts' decisions addressing the common-law strict-liability question is unconvincing, not only because they address the common-law question, but also because they are inconsistent with this Court's own prior decision in *Barbee* and the Restatement's guidance. Ultimately, however unclear and unsettled the common-law question may be in Texas or throughout the country, the question before us is not what the common law should be, but what Texas statutory law is. Even if the Court desires to limit the scope of the **[*67]** Product Liability Act's definition of "seller," we must apply the Act as written in this case, not announce common-law principles. "[A]s with any statute, we begin with the text," *City of DeSoto v. White, 288 S.W.3d 389, 395 (Tex. 2009)*, and when "the statute's language is unambiguous and does not lead to absurd results, our search also ends there: 'Where text is clear, text is determinative.'" *Tex. Adjutant Gen.'s Office v. Ngakoue, 408 S.W.3d 350, 362 (Tex. 2013)* (quoting *Entergy Gulf States, Inc. v. Summers, 282 S.W.3d 433, 437 (Tex. 2009))*. In short, the statutory definition—and "only" that definition—should control our decision in this case. *Needham, 82 S.W.3d at 318*.

**V.**

**Conclusion**

As part of its regular business for financial gain, Centerpoint contracted to transfer title of an allegedly defective truss from itself to Glenmont. It was thus a seller of the truss and not merely a facilitator of the sale. And making such sales was a regular part of the business in which Centerpoint was engaged. The summary judgment evidence in this case conclusively established that Centerpoint was "engaged in the business of distributing or otherwise placing" trusses "in the stream of commerce for use or consumption" and for a "commercial purpose." *Tex. Civ. Prac. & Rem. Code § 82.001(3)*. It was thus a "seller" under the Product Liability Act's plain language.

Of course, the Legislature could have defined the term "seller" to include only those who are "primarily" **[*68]** engaged in the business of distributing an allegedly defective product, who do not make such sales only "incidentally" as part of other business activities, who price the product to "achieve a profit" or "gain," or who do not sell "innumerable" other products in conjunction with the provision of a service. But it did not. Because the Court concludes that Centerpoint was not a seller when the Products Liability Act plainly says that it was, I respectfully dissent.

Jeffrey S. Boyd

Justice

Opinion delivered: June 17, 2016

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**Appellate History:**Requested

**Citing Decisions:**None Applied

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***Shepard's*®:** **Centerpoint Builders GP, LLC v. Trussway, Ltd.** 2016 Tex. LEXIS 505,59 Tex. Sup. Ct. J. 1295,CCH Prod. Liab. Rep. P19861: (Tex. 2016)

No subsequent appellate history. **Prior history** available.

## Appellate History (3)

### Prior

1. **Centerpoint Builders GP, LLC v. Trussway Ltd.**, 436 S.W.3d 882, 2014 Tex. App. LEXIS 7458, CCH Prod. Liab. Rep. P19428

   **Court:** Tex. App. Beaumont | **Date:** 2014

2. **Petition for review granted by:**
   **Centerpoint Builders Gp v. Trussway, Ltd.**, 2015 Tex. LEXIS 799

   **Court:** Tex. | **Date:** Sept. 4, 2015

3. Citation you *Shepardized*™
   **Affirmed by:**
   **Centerpoint Builders GP, LLC v. Trussway, Ltd.**, 2016 Tex. LEXIS 505, 59 Tex. Sup. Ct. J. 1295, CCH Prod. Liab. Rep. P19861

   **Court:** Tex. | **Date:** 2016

## Citing Decisions (0)

No documents found in Citing Decisions.

# Other Citing Sources: (2)

## Annotated Statutes

1. **Tex. Civ. Prac. & Rem. Code sec. 82.001**

   ... General contractor hired to construct an apartment complex was not “engaged in the business of” commercially distributing or placing trusses in the stream of commerce and thus it was not a “seller” entitled to seek indemnity because any sale of trusses was incidental to a contract to provide the services necessary to construct the building. **2016 Tex. LEXIS 505** . Torts: Products Liability: General Overview 34. Grant of summary judgment in favor of the manufacturer on a statutory indemnity claim ...

   **Content:** Statutes

2. **Tex. Civ. Prac. & Rem. Code sec. 82.002**

   ... **2016 Tex. LEXIS 505** . 95. One is not “engaged in the business of” selling a product for purposes of indemnity if providing that product is incidental to selling services. **2016 Tex. LEXIS 505** . 96. General contractor hired to construct an apartment complex was not “engaged in the business of” commercially distributing or placing trusses in the stream of commerce and thus it was not a “seller” entitled to seek indemnity because any sale of trusses was incidental to a contract to provide the services ...

   **Content:** Statutes

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# *Combs v. Health Care Servs. Corp.*

Supreme Court of Texas

February 27, 2013, Argued; June 7, 2013, Opinion Delivered

NOS. 11-0283, 11-0652

**Reporter**

401 S.W.3d 623; 2013 Tex. LEXIS 438; 56 Tex. Sup. J. 624; 2013 WL 2663985

SUSAN COMBS, COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS, AND , ATTORNEY GENERAL OF THE STATE OF TEXAS, PETITIONERS, v. HEALTH CARE SERVICES CORPORATION, RESPONDENT

**Subsequent History:** Released for Publication July 19, 2013.

**Prior History: [**1]** ON PETITION FOR REVIEW FROM THE COURT OF APPEALS FOR THE THIRD DISTRICT OF TEXAS.
*Combs v. Health Care Serv. Corp., 2011 Tex. App. LEXIS 5167 (Tex. App. Austin, July 7, 2011)*
*Combs v. Health Care Servs. Corp., 2011 Tex. App. LEXIS 2081 (Tex. App. Austin, Mar. 16, 2011)*

## Case Summary

### Procedural Posture

Petitioner state officials sought review of two decisions by the Court of Appeals for the Third District of Texas, which affirmed the trial court decision that respondent government contractor was entitled to a refund of sales taxes paid on tangible personal property, taxable services, and leases of tangible personal property. The cases were consolidated for purposes of appeal.

### Overview

*Tex. Tax Code Ann. § 151.006(a)(1)* applied to the tangible personal property where the contractor's normal course of business was performing federal government contracts, and the resale furthered those contracts. Further, the tangible personal property was automatically resold to the federal government as soon as it was acquired due to the title-transfer provisions of *Tex. Tax Code Ann. § 151.005(1)*. The court rejected the argument that *§ 151.006(a)(1)* required an essence of the transaction test as contrary to the statutory language. Neither the slight definitional change to the phrase "sale for resale" nor *Tex. Tax Code Ann. § 151.302(b)* abrogated case law and defeated the exemption. The exemption also applied to the taxable services where the contractor bought the taxable services then resold the services to the government by directing that they be performed on the government's behalf with the purpose of receiving reimbursement and compensation from the government. However, the leases of tangible personal property fell outside the exemption as there was no evidence that the contractor leased the property for the purpose of re-leasing it.

### Outcome

The decisions were affirmed in part and reversed in part. The cases were remanded to the trial court for further proceedings.

**Counsel:** For Combs, Susan (11-0652, 11-0283), Petitioner: Daniel T. Hodge, First Asst. Attorney General, Austin TX; David C. Mattax, Director of Defense Litigation, Office of the

Attorney General, Austin TX; Greg W. Abbott, Attorney General of Texas, Austin TX; Jim B. Cloudt, Office of the Attorney General, Taxation Division, Austin TX; Jonathan F. Mitchell, Solicitor General, Office of the Attorney General, Austin TX; Kristofer S. Monson, Assistant Solicitor General, Austin TX; William (Bill) J. Cobb III, Attorney General's Office, Deputy Atty. General for Civil Litigation, Austin TX.

For Combs, Susan (11-0283), Petitioner: Kevin D. Van Oort, Deputy Chief - Financial & Tax Litigation Div., Austin TX.

For Health Care Services Corporation (11-0652, 11-0283), Respondent: David E. Keltner, Kelly Hart & Hallman LLP, Fort Worth TX; Kennon Lathem Wooten, Ray H. Langenberg, Scott Douglass & Mcconnico LLP, Austin TX; Mark W. Eidman, Quentin Doug Sigel, Ryan Law Firm, LLP, Austin TX.

**Judges:** JUSTICE WILLETT delivered the opinion of the Court.

**Opinion by:** Don R. Willett

## Opinion

**[*624]** This tax-refund case concerns the Tax Code's sale-for-resale exemption, which grants purchasers of taxable goods and services a sales-tax exemption if they resell the items (since the ultimate purchaser will pay any tax due). Here, a government contractor seeks sales-tax refunds for purchases used to administer federal health-insurance programs. The question is one of scope: What categories of purchases qualify for the exemption?

Applying the Legislature's sale-for-resale definition and exemption language, we believe the contractor here is entitled to most of the claimed refunds. There are three main categories of goods and services for which refunds are claimed: tangible personal property, taxable services, and leases of tangible personal property. We hold that the exemption applies to the tangible personal property and taxable services, but not to the leases of tangible **[*625]** personal property, for the following reasons:

- Tangible Personal Property. The exemption applies even when, as here, the resale consists of bare title transfer of tangible **[**2]** personal property that is consumed by the taxpayer to perform nontaxable services. This holding reaffirms long-standing precedent that allowed federal contractors to claim the sale-for-resale exemption for tangible personal property subject to automatic title transfer. We hasten to note, however, that a 2011 Tax Code amendment likely alters this result moving forward.

- Taxable Services. Sale-for-resale of a taxable service can occur, as here, by directing that the service be performed for another party in return for consideration from that party.

- Leases of Tangible Personal Property. These fall outside the sale-for-resale exemption, as they are not resold unless they are re-leased or transferred in some other way to another purchaser.

Finally, we hold that reimbursement of a tax is not the same as collection of a tax. Thus, the requirement that a taxpayer who claims a refund show he has not collected the tax from someone else does not also require the taxpayer to show he has not been reimbursed for the tax. Accordingly, we affirm the court of appeals' judgment on all but the lease issue, which we reverse and remand to the trial court for further proceedings.

## I. Background

Health Care **[**3]** Services Corporation and its predecessor-in-interest, Blue Cross and Blue Shield of Texas, Inc. (collectively HCSC), contracted with the federal government to administer two health-insurance programs.[1] While performing these contracts, HCSC incurred expenses that were reimbursed by the federal government.

HCSC paid sales and use tax on some of these expenses and applied for a refund under the sale-for-resale exemption.[2] The Comptroller denied the refund. HCSC brought two separate tax-refund suits, the first covering December 1, 1988 through December 31, 1998, and the second covering January 1, 1999 through December 31, 2003. The two cases were nearly identical except for minor variations in the specific property and services for which HCSC sought a sales-tax refund.[3] However, in both cases, HCSC claimed the sale-for-resale **[**4]** exemption for three general categories of property and services it used to perform the contracts: (1) tangible personal property (such as chairs, printers, and office supplies); (2) taxable services (such as printer repair services, landscape maintenance, and copier maintenance); and (3) **[*626]** leases of certain tangible personal property (such as leases of computers, audio equipment, and printers).

In both cases, the court of appeals affirmed trial-court decisions that HCSC was entitled to the claimed refunds.[4] We consolidated the cases and issue this joint decision.

## II. [**5] Discussion

The Comptroller argues the sale-for-resale exemption is inapplicable and also that HCSC should have to prove the federal government did not already reimburse it for the sales tax for which it requests refunds.

We affirm in part, reversing solely on the leases of tangible personal property. HCSC is entitled to a sales-tax refund for the tangible personal property and taxable services but not for the leases of tangible personal property. Also, HCSC need not show whether the federal government reimbursed it for the taxes.

### A. Tangible Personal Property

At all relevant times, the Tax Code defined sale for resale as a sale of:

> tangible personal property or a taxable service to a purchaser who acquires the property or service for the purpose of reselling it [in certain geographical locations] in the normal course of business in the form or condition in which it is acquired or as an attachment to or integral part of other tangible personal property or taxable service.[5]

The statute applies to the tangible personal property here. HCSC purchased the "tangible personal property" for the purpose of "reselling it . . . in the normal course of business in the form or condition in which it [was] **[**6]** acquired." The trial court found that

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[1] HCSC performed administrative services for two types of health insurance programs: Medicare and the Federal Employees Health Benefits Program. However, the contracts for both programs were virtually identical for the purposes of this opinion. So, all references in this opinion to "the contracts" are references to all contracts related to both programs, unless otherwise indicated.

[2] For clarity, we will abbreviate "sales and use tax" to just "sales tax."

[3] In the first trial, the specific property or services were: "Utilities," "Taxable Services on Tangible Personal Property," "Allowable," "Capitalized Assets," "Leases," "Maintenance on Tangible Personal Property," and "Software/Software Maintenance." In the second trial, the specific property or services were: "Utilities," "Taxable Services on Tangible Personal Property," "Taxable Services on Real Property," "Allowable," "Leases," "Maintenance on Tangible Personal Property," "Maintenance on Real Property," and "Software/Software Maintenance."

[4] __ S.W.3d __; __ S.W.3d __.

[5] Act of May 27, 2007, 80th Leg., R.S., ch. 1266, § 2, 2007 Tex. Gen. Laws 4234, 4234 (amended 2011) (current version at *Tex. Tax Code § 151.006(a)(1)*).

HCSC's normal course of business was performing federal government contracts, and the resale furthered those contracts. Further, the tangible personal property was automatically resold to the federal government as soon as it was acquired due to the title-transfer provisions.[6] Title transfer for consideration is one type of "sale."[7] Therefore, the property was resold (through title transfer) in the "form or condition in which it [was] acquired": the resale was automatic upon acquisition, so, naturally, the property was resold before HCSC had any chance to alter it.

The Comptroller asserts that *Section 151.006(a)(1)* requires the application of an **[*627]** "essence of the transaction" test. The Comptroller's argument is essentially that the exemption should only apply if the *primary* purpose of the original sale is to resell "in the form or condition in which it is acquired or as an attachment to or integral part of other tangible personal **[**8]** property or taxable service." Here, the primary purpose of the original sale was to acquire property that would be consumed in performing a nontaxable service, so the exemption should not apply. This restrictive interpretation collides with the statutory text.

The exemption does not say (or even intimate) that the *primary* purpose of the sale must be for a particular kind of resale.[8] The statute merely says the sale must have "the purpose" of reselling in one of the specified ways; not "the primary purpose," "the main purpose," or "the important purpose." Here, HCSC bought tangible personal property for *the purpose* of transferring its title to the federal government; we know this was the purpose because it was an unavoidable result given the automatic title-transfer provision. It is irrelevant that a second purpose of the sale was to acquire property that would be consumed in performing the nontaxable services. Taking the Legislature at its word and giving the statute its plain meaning, the definition and exemption apply.

This plain-text analysis reaffirms our holding in *Day & Zimmerman, Inc. v. Calvert*.[9] That case involved a taxpayer, Day & Zimmerman, that contracted with the federal government "for the loading, assembling and packaging of ammunition and related components as well as the handling of the mechanics of procurement of all necessary materials, supplies, equipment

[6] We note that the trial court concluded that the title-transfer provisions apply to all the tangible personal property transfers. The Comptroller does not contest this conclusion or argue that the title-transfer provisions were limited to certain types of transactions. Therefore, we treat all the tangible personal property purchases identically without independently analyzing whether the title-transfer provisions were applicable to all the **[**7]** transactions. We note, however, that the different contracts incorporated different title-transfer provisions. The earlier Federal Employees Health Benefits Program contracts incorporated the title-transfer provision found in Federal Acquisition Regulation 52.245-2, while later, amended Federal Employees Health Benefits Program contracts incorporated the title-transfer provision found in Federal Employees Health Benefits Acquisition Regulation 1652.245-70. The Medicare contracts all incorporated the title-transfer provision found in Federal Acquisition Regulation 52.245-5. As the parties have not raised the issue, we express no opinion on whether these different title-transfer provisions properly apply to all of the tangible personal property transfers at issue here. *See* *Tex. R. App. P. 55.2(i)*.

[7] *Tex. Tax Code § 151.005(1)*.

[8] We recently noted that "in the area of tax law, like other areas of economic regulation, a plain-meaning determination should not disregard the economic realities underlying **[**9]** the transactions in issue," and cited federal and Texas tax cases referencing "economic realities" or the "essence of the transaction." *Combs v. Roark Amusement & Vending, L.P., 422 S.W.3d 632, 2013 Tex. LEXIS 179 & n.14 (Tex. 2013)*. However, we also made clear that if the statute does "not impose, either explicitly or implicitly," the "extra-statutory requirement" urged by the Comptroller, "we decline to engraft one—revising the statute under the guise of interpreting it." *Id. at 637, 2013 Tex. LEXIS 179 at *11*. We did not suggest that, in the guise of considering the economic realities or essence of the transaction, courts were authorized to impose an entirely new requirement for a tax exemption that simply is not found in the language of the statutory exemption.

[9] *519 S.W.2d 106 (Tex. 1975)*

and services."[10] The contract between Day & Zimmerman and the government contained an automatic title-transfer **[**10]** provision similar to the one here.[11] The Comptroller made a deficiency determination against Day & Zimmerman for the sales tax paid for "the tangible personal property, not including any of the component parts that went into the finished product, purchased and consumed by the operating contractor in the performance of its contract with the Federal Government."[12] We held that the sales tax for this property had to be refunded to Day & Zimmerman because the transaction fell within the sale-for-resale exemption. The sale happened when the tangible personal property was physically transferred from the vendor to Day & Zimmerman.[13] Then, because the definition of "sale" included title transfer for consideration, the resale happened when title to the property transferred **[*628]** from Day & Zimmerman to the federal government.[14] *Day & Zimmerman* is thus completely consistent with our decision today, both in its holding and its reasoning.

We find unpersuasive the Comptroller's attempt to distinguish *Day & Zimmerman*. The Comptroller argues that *Day & Zimmerman* involved a contract where the "essence **[**11]** of the transaction" was selling goods, whereas the essence of the transaction here is selling nontaxable services to which Section 151.006(a)(1) does not apply. So, the Comptroller says *Day & Zimmerman* is consistent with her proposed essence of the transaction test. The difficulty with this reasoning is simply stated: *Day & Zimmerman* never mentions or alludes to any such test. Moreover, it's anything but clear whether the essence of the transaction was reselling tangible personal property (ammunition) or reselling services (assembly and packaging of ammunition).[15] If the essence of the transaction really mattered, we would expect a more detailed description of the contract's "essence." *Day & Zimmerman* did not contemplate an "essence of the transaction" test because no such discussion exists. Instead, *Day & Zimmerman* stands for the proposition that automatic title transfer upon purchase qualifies for the sale-for-resale exemption. *Day & Zimmerman* cuts squarely in HCSC's favor due to the analogous title-transfer provisions.

The Comptroller next urges that *Day & Zimmerman* was abrogated by amendments to the sale-for-resale statute. While conceding that "sale" is still defined **[**12]** to include bare transfer of title of tangible personal property for consideration,[16] she asserts that two amendments have changed the legal landscape and rendered *Day & Zimmerman* irrelevant: (1) a change to the definition of "sale for resale," and (2) a new provision dealing with certain transactions that mix the resale of tangible personal property with the resale of taxable services. Upon careful examination of the amendments, the Comptroller's argument fails.

*1. The Slight Definitional Change to "Sale for Resale" Does Not Abrogate Day & Zimmerman and Defeat the Exemption*

In *Day & Zimmerman*, the statutory definition of sale for resale was:

> A sale of tangible personal property to any purchaser who is purchasing said tangible property for the purpose of reselling it [in

[10] Id. at 108.

[11] Id. at 110.

[12] Id. at 108.

[13] Id. at 109-11.

[14] Id. at 110.

[15] *See* id. at 108.

[16] *See* Tex. Tax Code § 151.005(1).

> certain geographical locations] in the normal course of business either in the form or condition in which it is purchased, or as an attachment to, or integral part of, other tangible personal property.[17]

The statutory definition relevant to this case reads:

> [A sale of] tangible personal property or a taxable service to a purchaser who acquires the property or service for the purpose of reselling **[**13]** it [in certain geographical locations] in the normal course of business in the form or condition in which it is acquired or as an attachment to or integral part of other tangible personal property or taxable service.[18]

**[*629]** Studying these similar statutes, it is difficult to understand the Comptroller's argument that the statutory definition has changed so much as to revoke *Day & Zimmerman*. The new version merely seems to recognize the fact that some services are now taxable in Texas, whereas they were not when *Day & Zimmerman* was decided almost forty years ago.

The Comptroller's main argument appears to be that adding the words "taxable service" throughout the definition makes it clear that tangible personal property cannot be considered "resold" if the property is merely used to provide a nontaxable service. After all, says the Comptroller, the definition doesn't mention *nontaxable* services. But the *Day & Zimmerman*-era statute similarly made it clear that tangible personal property could not be considered **[**14]** "resold" if it was merely used to provide a service because the definition did not mention *any* services.

The Comptroller also argues that the statutory change unambiguously requires (or, in the alternative, ambiguously allows) application of the "essence of the transaction" test. The trouble with this argument, again, is that the changes since *Day & Zimmerman* say nothing about the "essence of the transaction" test. We do not see how the revisions have introduced any ambiguity into the statute that would allow application of the "essence of the transaction" test when it did not apply in *Day & Zimmerman*. In sum, the definitional changes to "sale for resale" do not statutorily abrogate *Day & Zimmerman*.

*2. New Tax Code Section 151.302(b) Similarly Does Not Abrogate Day & Zimmerman and Defeat the Exemption*

The Comptroller next argues that *Day & Zimmerman* was abrogated by Section 151.302(b), which provides:

> Tangible personal property used to perform a taxable service is not considered resold unless the care, custody, and control of the tangible personal property is transferred to the purchaser of the service.[19]

But it is uncontested in this case that HCSC is asking for a refund for tax paid on **[**15]** tangible personal property used to perform a *nontaxable* service because administrative services are not listed as a taxable service in Section 151.0101(a). Tangible personal property used to perform a nontaxable service is outside the exception to the exemption created by Section 151.302(b); by its own terms, that section only applies to tangible personal property used to perform a *taxable* service.

[17] Day & Zimmerman, 519 S.W.2d at 109.

[18] Act of May 27, 2007, 80th Leg., R.S., ch. 1266, § 2, 2007 Tex. Gen. Laws 4234, 4234 (amended 2011) (current version at Tex. Tax Code § 151.006(a)(1)).

[19] Tex. Tax Code § 151.302(b).

Perhaps it seems strange to distinguish between taxable and nontaxable services in *Section 151.302(b)*. After all, if HCSC had transferred bare title to the tangible personal property and then consumed it in performing a *taxable* service, HCSC would not be entitled to a reimbursement. However, we read unambiguous statutes as they are written, not as they make the most policy sense. If a statute is worded clearly, we must honor its plain language, unless that interpretation would lead to absurd results. The Comptroller urges deference to its interpretation, but we recently canvassed our articulations of the agency-deference doctrine and formulated this test:

> We have long held that an agency's interpretation of a statute it is charged with enforcing is entitled to "serious **[**16]** consideration," so long as the construction is reasonable and does not conflict with the statute's language. . . . In our "serious consideration" inquiry, we will generally uphold an agency's interpretation **[*630]** of a statute it is charged by the Legislature with enforcing, so long as the construction is reasonable and does not contradict the plain language of the statute. . . . [T]his deference is tempered by several considerations: [the statute must be ambiguous, the agency interpretation must be the result of formal procedures, and the interpretation must be reasonable].[20]

It is true that courts grant deference to an agency's reasonable interpretation of a statute, but a precondition to agency deference is ambiguity; "an agency's opinion cannot change plain language."[21] There is no ambiguity about the ambiguity requirement, nor with the unassailable rule that agency interpretations cannot contradict statutory text. Here, the Comptroller's interpretation is contrary to the Tax Code. The statute unambiguously applies only to tangible personal **[**17]** property used to perform a taxable service. Further, it is not absurd for the Tax Code to treat nontaxable services more favorably than taxable services; indeed, the Tax Code already treats nontaxable services more favorably by not taxing them. Summing up: As *Section 151.302(b)* explicitly applies only to tangible personal property used to perform taxable services, we decline the Comptroller's invitation to rewrite the statute to reach nontaxable services, too.

*3. Given the Statute's Clarity, the Comptroller's Unintended Consequences Arguments Are Unavailing*

The Comptroller contends the Legislature could not have intended to exempt HCSC from sales tax for items it consumed itself. Arguing that a plain-language interpretation of the exemption would produce unintended consequences, she asserts the "tie-pin" example: that HCSC should not be refunded sales tax on tie pins it bought to reward its employees for good work.

We recognize that statutes, framed in general terms, can often work peculiar outcomes, including over-or under-inclusiveness, but such minor deviations do not detract from the statute's clear import. If an as-written **[**18]** statute leads to patently nonsensical results, the "absurdity doctrine" comes into play, but the bar for reworking the words our Legislature passed into law is high, and should be. The absurdity safety valve is reserved for truly exceptional cases, and mere oddity does not equal absurdity. A sales-tax exemption for tie pins, even if unintended, even if improvident, even if inequitable, falls short of being unthinkable or unfathomable. The absurdity backstop requires more than a curious loophole. Indeed, given the complexity of

[20] *R.R. Comm'n of Tex. v. Tex. Citizens for a Safe Future & Clean Water, 336 S.W.3d 619, 624-25 (Tex. 2011)* (internal quotation and citation omitted).

[21] *Fiess v. State Farm Lloyds, 202 S.W.3d 744, 747 (Tex. 2006)*.

modern tax laws (and the haste with which many are enacted), whimsical examples of over-or under-inclusiveness, likely wholly unintended, doubtless abound.[22] But pointing out a **[*631]** quirky application is quite different from proving it was quite impossible that a rational Legislature could have intended it.

Since at least *Day & Zimmerman*, items consumed while performing a contract with a title-transfer provision have clearly been covered by the sale-for-resale exemption. If the Legislature considered this a loophole worth closing, it could have done so. In fact, lawmakers in 2011 narrowed it via *Section 151.006(c)*, which reserves this sale-for-resale exemption to contractors that are partnering with federal national security-related agencies.[23]

### B. [**21] Taxable Services

The Comptroller argues that the taxable services that HCSC bought on the government's behalf fall outside the sale-for-resale exemption because the title-transfer clauses did not transfer title of the taxable services to the federal government. However, title transfer clearly is not the only way to bring about a resale. Instead, "sale" also includes "performance of a taxable service" for consideration.[24] Here, HCSC bought these taxable services (the sale). HCSC then resold the services to the government by directing that they be performed on the government's behalf with the purpose of receiving reimbursement and compensation (consideration) from the government (the resale). The sale-for-resale exemption explicitly includes the sale-for-resale of a service when it is resold "in the form or condition in which it is acquired."[25] Here, HCSC bought the services and then immediately resold them to the federal government, so the services were resold in the same form as they were acquired, thus qualifying for the sale-for-resale exemption.

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[22] Partly because of the title-transfer provision, the federal government likely could have demanded at any time that HCSC turn over all tangible personal property that wasn't consumed yet (even the tie pins). Indeed, the trial court found that when certain HCSC contracts expired, the federal government required HCSC physically to transfer any remaining tangible **[**19]** personal property to the new contractor. Title transfer was not a mere sham here; it had a real-world impact on HCSC. The federal government owned the tangible personal property, even if it lacked physical control over it. It thus makes some sense to shield HCSC from the tax burden for all property purchased to carry out the contracts.

[23] *See Tex. Tax Code § 151.006(c)* which provides:

> A sale for resale does not include the sale of tangible personal property or a taxable service to a purchaser who acquires the property or service for the purpose of performing a service that is not taxed under this chapter, regardless of whether title transfers to the service provider's customer, unless the tangible personal property or taxable service is purchased for **[**20]** the purpose of reselling it to the United States in a contract, or a subcontract of a contract, with any branch of the Department of Defense, Department of Homeland Security, Department of Energy, National Aeronautics and Space Administration, Central Intelligence Agency, National Security Agency, National Oceanic and Atmospheric Administration, or National Reconnaissance Office to the extent allocated and billed to the contract with the federal government.

*See also id. § 151.006(a)(5)* which provides that a "sale for resale" means:

> except as provided by Subsection (c), tangible personal property to a purchaser who acquires the property for the purpose of transferring it as an integral part of performing a contract, or a subcontract of a contract, with the federal government only if the purchaser:
>
> > (A) allocates and bills to the contract the cost of the property as a direct or indirect cost; and
> >
> > (B) transfers title to the property to the federal government under the contract and applicable federal acquisition regulations.

Both of these subsections were added in 2011. Act of June 28, 2011, 82d Leg., 1st C.S., ch. 4, § 12.01, 2011 Tex. Gen. Laws 5263, 5263 (current version at *Tex. Tax Code § 151.006*).

[24] *Tex. Tax Code § 151.005(3)*.

[25] Act of May 27, 2007, 80th Leg., R.S., ch. 1266, § 2, 2007 Tex. Gen. Laws 4234, 4234 (amended 2011) (current **[**22]** version at *Tex. Tax Code § 151.006(a)(1)*).

The Comptroller attempts to recharacterize HCSC's sale-for-resale of services as sale-for-resale of service *contracts*. However, the trial court's findings of fact include findings that the services at issue **[*632]** were performed on behalf of the federal government and that HCSC was compensated for them. Therefore, because the Comptroller has not challenged the evidentiary sufficiency of these factual findings, we accept them as a true characterization of the transfer. That is, the resale to the government was the performance of the services for consideration, not merely a resale of service contracts.

### C. Leases of Tangible Personal Property

The Comptroller further argues that the leases of tangible personal property fall outside the sale-for-resale exemption. After all, the Comptroller says, leases themselves are not tangible personal property, so sale-for-resale of a lease is not the sale-for-resale of tangible personal property. But "lease" is statutorily included in the definition of "sale."[26] Therefore, lease-for-(re)lease of tangible personal property falls within the definition of sale-for-resale of tangible personal property.

That **[**23]** said, there is no evidence here that HCSC leased the property for the purpose of *re-leasing* it. That is, using the property for the federal government contract is not the same as formally re-leasing the property to the federal government. The trial court pointed out that some leased property was transferred to the new contractor after HCSC's contract ended. But there is no finding or even allegation that HCSC's *purpose* in leasing the property in the first place was to re-lease it to the federal government or another contractor. Instead, the transfer of the leased property apparently only happened because the federal contract ended, not because the original purpose of leasing the property was to re-lease it. Thus, HCSC is not due a refund on sales tax paid on the leases.

### D. Documentation of Reimbursements

HCSC is not required to produce documentation proving it did not receive federal government reimbursement for the sales tax it paid. *Section 111.104(f)* provides:

> No taxes, penalties, or interest may be refunded to a person who has *collected* the taxes from another person unless the person has refunded all the taxes and interest to the person from whom the taxes were *collected*.[27]

The Comptroller **[**24]** argues that this section imposes a burden on HCSC to show it was never reimbursed for the taxes it is seeking to have refunded. The Comptroller claims that HCSC can't prove that here.[28] But the statute precludes a refund only if HCSC *collected* a tax, not just if it was reimbursed some amount that may or may not include a tax. The Comptroller claims that being reimbursed for a tax is equivalent to collecting a tax. That is simply not the case. At all times relevant to this dispute, the Tax Code provided that a person who collects a tax holds that money in trust for the State.[29] Such a trust relationship clearly did not exist here; the federal government did not pay HCSC tax for it to hold in trust and then remit to the State. Further, in the sales tax context, **[*633]** tax is collected by a seller adding the sales tax to an initial sales price and

[26] *Tex. Tax Code § 151.005(2)*.

[27] *Id. § 111.104(f)* (emphasis added).

[28] In contrast, the trial court seemed to find some circumstantial evidence that the federal government had not reimbursed HCSC for the taxes because HCSC was operating at a loss.

[29] *Tex. Tax Code § 111.016* **[**25]** ("Any person who receives or collects a tax or any money represented to be a tax from another person holds the amount so collected in trust for the benefit of the state and is liable to the state for the full amount collected plus any accrued penalties and interest on the amount collected.").

then charging that amount to the buyer as part of the new sales price.[30] Such a collection process did not occur here.

That is, contrary to the Comptroller's argument, collecting a tax is not the same as reimbursing a tax. Hypothetically, a contractor and the federal government could agree for the government to pay ten percent of sales tax as part of the consideration for the contract; this would not mean that the contractor would "collect" ten percent of sales tax from the federal government. Instead, the sale price itself would go up by ten percent of the sales tax rate. Such a contract might actually be sensible if a federal contractor foresaw having to fight with the Comptroller to get a refund for the tax. A very similar (although less transparent) contractual arrangement may have occurred here; the federal government may have **[**26]** paid part of the sales tax price as part of the consideration for the contract.

However, if the federal government's contractual arrangement did not intend to pay HCSC for sales tax that was ultimately refunded, the federal government can likely recover the portion of the sales tax that it paid.[31] Therefore, the risk of HCSC receiving an unintended windfall at the federal government's expense is slight.

Regardless, though, as explained above, the statute designed to prevent double recovery (*Section 111.104(f)*) is inapplicable in light of the fact that HCSC never "collected" tax from the federal government, which is a prerequisite for the statute's application.[32] Our statutory interpretation is reinforced by the fact that it makes sense from a policy perspective to prevent refund of tax only when it is explicitly collected from (i.e., charged as tax to) the buyer. After all, when such a tax **[**27]** is charged to a buyer, the buyer's understanding is that the portion of the sale attributed to tax will be paid to the government. The buyer also knows that any profit the seller makes in the transaction is through the sales price alone. On the other hand, with a lump sum charge to a customer that does not clearly delineate sales tax, the customer has no such expectation that a certain portion will be remitted to the State. It would also make very little sense to make federal government contractors write up transaction-by-transaction receipts with line items saying "Tax Collected = 0" for each transaction. Money is plainly and inarguably fungible, so even if the tax collected is listed as zero, federal contractors could just increase the amount they are paid under the contract to cover any money spent on sales tax. There is no reason to force contractors to engage in such creative accounting when the statute itself does not dictate that result.

## III. Conclusion

We affirm in part and reverse in part, holding that HCSC is entitled to a sales- **[**28]** and use- tax refund for all the transactions except the leases of tangible personal **[*634]** property. We remand to the trial court for further proceedings consistent with this opinion.

Don R. Willett

Justice

[30] *Id.* *§ 151.052(a)* ("COLLECTION BY RETAILER. . . . [A] seller who makes a sale subject to the sales tax imposed by this chapter shall add the amount of the tax to the sales price.").

[31] *See* *Hercules Inc. v. United States, 292 F.3d 1378, 1382-83 (Fed. Cir. 2002)* (when federal government contract incorporates certain Federal Acquisition Regulations, any state tax refund must be remitted to the United States in the same proportion that the federal government paid the original tax).

[32] The Legislature *could* impose a record-keeping requirement when a tax is reimbursed rather than collected, but *Section 111.104(f)* does not do so.

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# *Combs v. Newpark Res., Inc.*

Court of Appeals of Texas, Third District, Austin

December 31, 2013, Filed

NO. 03-12-00515-CV

**Reporter**

422 S.W.3d 46; 2013 Tex. App. LEXIS 15455; 2013 WL 6920878

Susan Combs, Comptroller of Public Accounts of the State of Texas; and Greg Abbott, Attorney General of the State of Texas, Appellants v. Newpark Resources, Inc., Appellee

**Prior History: [**1]** FROM THE DISTRICT COURT OF TRAVIS COUNTY, 250TH JUDICIAL DISTRICT. NO. D-1-GN-11-002205, HONORABLE TIM SULAK, JUDGE PRESIDING.

**Disposition:** Affirmed.

## Case Summary

### Overview

ISSUE: Whether a taxpayer group could deduct the cost of a member's labor in disposing of drilling mud from the group's franchise tax. HOLDINGS: [1]-Under the cost-of-goods-sold deduction, each member was considered part of the group's business, not individually, because *Tex. Tax Code Ann. § 171.1014(e)* did not require each member to be isolated; [2]-The member's expenses were costs of goods sold under *Tex. Tax Code Ann. § 171.1012(i)* because the member furnished "labor" to a project for the construction of real property, drilling wells was an improvement to real property, removing drilling mud was labor furnished for the construction of wells, and the transport and disposal of used drilling mud was part of the labor involved in the drilling process, as it was essential to the process.

### Outcome

Judgment affirmed.

**Counsel:** For Appellee: Mr. James F. Martens, Ms. Danielle V. Ahlrich, Ms. Lacy L. Leonard, Martens, Todd & Leonard, Austin, TX; Ms. Amanda G. Taylor, Hohmann, Taube & Summers, L.L.P., Austin, TX.

For Appellant: Mr. Charles K. Eldred, Assistant Attorney General, Financial Litigation, Tax, and Charitable Trusts Division, Austin, TX.

**Judges:** Before Chief Justice Jones, Justices Pemberton and Field.

**Opinion by:** Scott K. Field

## Opinion

**[*47]** In this suit to recover franchise taxes paid under protest, appellants Susan Combs, Comptroller of Public Accounts for the State of Texas, and Greg Abbott, Attorney General of the State of Texas (collectively, the Comptroller), appeal from the trial court's final judgment in favor of appellee Newpark Resources, Inc. On appeal, the Comptroller asserts that the trial court erred in concluding that Newpark was entitled to a tax refund because (1) Newpark's subsidiary, Newpark Environmental Services, LLC (NES), did not qualify for a cost-of-goods-sold deduction and (2) Newpark was not entitled to exclude from its total revenue NES's payments to subcontractors. *See* Tex. Tax Code §§ 171.1011(g)(3), 171.1012. We affirm the trial court's judgment.

## BACKGROUND

### Structure of the franchise tax

Because this Court has not previously analyzed the most recent incarnation of Texas's franchise tax, we begin our discussion with a brief overview of the franchise tax. The franchise tax is a tax on the value **[**2]** and privilege of doing business in Texas. *See* In re Nestle USA, Inc., 387 S.W.3d 610, 612 (Tex. 2012 ) (orig. proceeding). The tax was enacted in 1893 but has been significantly restructured several times. *See* id. at 612-13 (discussing history of franchise tax). The current version of the franchise tax is codified in chapter 171 of the Tax Code, which was adopted in 2006 as part of the legislature's "effort to provide lasting property tax relief, establish a stable and long-term source of funding for public schools, and meet the June 1, 2005 deadline set in *West Orange-Cove*." In re Allcat Claims Serv., L.P., 356 S.W.3d 455, 458-59 (Tex. 2011) (orig. proceeding) (citing Neeley v. West Orange-Cove Consol. Indep. Sch. Dist., 176 S.W.3d 746, 753-54 (Tex. 2005) (concluding that previous school-funding scheme was unconstitutional)). "The tax is still based primarily on revenue and only secondarily on capital, and now applies to every for-profit entity doing business or chartered in Texas that is distinct from its owners." In re Nestle USA, 387 S.W.3d at 614.

As the supreme court explained, the current franchise tax is generally calculated using the following formula:

> Total Revenue — General **[**3]** Deduction: the greater of either the Cost of Goods Sold, Compensation, or 30%
>
> = Margin
>
> x Percentage of gross receipts from Texas business
>
> = Taxable Margin
>
> x Tax Rate (0.5% for entities primarily engaged in wholesale or retail trade, 1% for all others)
>
> = Franchise tax

*Id*.

The calculation of total revenue is governed by section 171.1011 of the Tax Code. Generally, total revenue is "income reported to the federal IRS with various deductions, limitations, and exceptions." *See* id. at 615 (listing several exclusions from total revenue). The relevant revenue exclusion in this case is set out in section 171.1011(g)(3) and requires a taxable entity to exclude from total revenue all "flow-through funds that are mandated by contract to be distributed to" subcontractors that "provide services, labor, or materials in connection with" various improvements to real property.

After calculating total revenue, a taxable entity may take one of three general deductions: cost of goods sold, compensation, **[*48]** or 30% of total revenue. The cost-of-goods-sold deduction, which is the deduction Newpark elected to take in this case, is governed by section 171.1012 of the Tax Code. This provision allows a company to deduct **[**4]** "'all direct costs of acquiring or producing goods,' some indirect costs like insurance, utilities, and quality control, and up to 4% of other 'indirect or administrative overhead costs.'" *See id*. (quoting Tex. Tax Code § 171.1012(a)(1), (c)—(d), (f)).

Newpark and its subsidiaries are "[a]ffiliated entities engaged in a unitary business." In re Nestle USA, Inc., 387 S.W.3d at 614; *see also* Tex. Tax Code § 171.1014. Therefore, Newpark files a single tax report for the combined group. The group must elect to take the same general deduction—meaning all members must take either a cost-of-goods-sold, compensation, or 30% deduction. *See* *Tex. Tax Code § 171.1014(d)*. With this background in mind, we turn to the specific facts of this case.

**Factual and procedural background**

Newpark describes itself as an "integrated oilfield services company," providing services to third-party "exploration and production companies" that are necessary for the drilling of oil and gas wells. Newpark's primary business activity—at least with respect to the disputed issues in this case—involves the manufacture, sale, injection, and removal of "drilling mud."[1] Drilling mud is a product that is injected into a well hole **[**5]** as it is being drilled to cool and lubricate the drill as well as to facilitate the removal of rock, soil, and other "waste material" from the hole.

Newpark, as the parent company, uses several subsidiaries for its various drilling-mud operations. One subsidiary manufactures the industrial minerals that go into making drilling mud; another subsidiary produces, sells, injects, and removes the drilling mud from the well; and NES—the main subsidiary at issue in this appeal—removes the resulting nonhazardous waste materials from the drilling site, transports the waste to NES's underground disposal sites, and injects the waste into the sites for permanent disposal. NES hires subcontractors to operate the trucks and barges that haul waste to the disposal sites.

Newpark explained that its customers generally purchase **[**6]** Newpark's services as an "integrated service package" rather than separately from each subsidiary. Contracts are usually between the customer and Newpark and its "subsidiaries and affiliated companies unless expressly excluded by written agreement." These contracts generally do not specify what subcontractors, if any, Newpark or its subsidiaries will use to provide their services.

The Comptroller conducted a "desk audit" of Newpark's franchise-tax returns for 2008 and 2009 and asked Newpark to explain its subsidiaries' business activities. Newpark explained NES's business as outlined above, and based on that description, the Comptroller determined that Newpark owed an additional $186,547.03 for 2008 and $205,698.98 for 2009, plus penalties and interest. This adjustment was based on the Comptroller's determination that NES's disposal of waste material was a service that did not qualify for a cost-of-goods-sold deduction. Newpark paid the **[*49]** additional tax under protest and filed this underlying protest suit.

In its suit, Newpark asserted that it was entitled to include NES's expenses in Newpark's overall cost-of-goods-sold deduction. *See id.* *§ 171.1012*. Alternatively, Newpark argued that **[**7]** it was entitled to exclude a nearly equivalent amount from its total revenue based on NES's flow-through payments to subcontractors for hauling the waste.[2] *See id.* *§ 171.1011(g)(3)*. Newpark also claimed additional cost-of-goods-sold deductions for its various indirect and administrative overhead expenses that were not included in Newpark's original tax return. *See id.* *§ 171.1012(f)*.

[1] Newpark also provides other services to drilling operations, including manufacturing and renting "composite mats" and other "initial planning and drill-site-location and construction services." Although these other activities may be included in Newpark's overall revenue and, by extension, be subject to the franchise tax, they are generally not relevant to the issues in this appeal.

[2] As the statute makes clear, if a taxable entity excludes flow-through payments to subcontractors from its total revenue, it cannot claim those same payments in its cost-of-goods-sold deduction. *See* *Tex. Tax Code § 171.1011(i)*. The value of Newpark's alleged exclusions and deductions are not in dispute, and NES's proposed cost-of-goods-sold deduction is slightly larger than its proposed flow-through revenue exclusion.

Following a bench trial, the trial court rendered a final judgment in Newpark's favor, concluding that Newpark was entitled to a refund of $472,872, plus statutory interest. The Comptroller did not timely request, and the trial court did not issue, findings of fact and conclusions of law. However, to reach the amount of Newpark's refund, the trial court must have concluded that Newpark was entitled **[**8]** to claim NES's expenses—including its indirect and administrative overhead expenses—in Newpark's overall cost-of-goods-sold deduction. *See supra* n.2. This appeal followed.

## STANDARD OF REVIEW

The trial court, acting as factfinder, is the sole judge of credibility of the witnesses and weight to be given to their testimony. *McGalliard v. Kuhlmann, 722 S.W.2d 694, 696 (Tex. 1986)*. Where, as in this case, no findings of fact or conclusions of law are filed or requested, we must infer that the trial court made all findings necessary to support its judgment. *Holt Atherton Indus., Inc. v. Heine, 835 S.W.2d 80, 83 (Tex. 1992)*. When the implied findings of fact are supported by the evidence, we must affirm the trial court's judgment on any theory of law applicable to the case. *See In re W.E.R.*, 669 S.W.2d 716, 717 (Tex. 1984); *Carrollton-Farmers Branch Indep. Sch. Dist. v. JPD, Inc., 168 S.W.3d 184, 188 (Tex. App.—Dallas 2005, no pet.)*.

The issues in this case primarily concern the proper construction of chapter 171 of the Tax Code. *See generally Tex. Tax Code §§ 171.1011-.1014*. Statutory construction is a question of law that we review de novo. *See First Am. Title Ins. Co. v. Combs, 258 S.W.3d 627, 631 (Tex. 2008)*. **[**9]** When construing a statute, our primary objective is to ascertain and give effect to the legislature's intent. *Id. at 631-32*. In determining legislative intent, we first consider the plain language of the statute. *GMC v. Bray, 243 S.W.3d 678, 685 (Tex. App.—Austin 2007, no pet.)*. When statutory text is clear, it is determinative of legislative intent, unless enforcing the plain meaning of the statute's words would produce an absurd result. *Entergy Gulf States, Inc. v. Summers, 282 S.W.3d 433, 437 (Tex. 2009)*. We consider the statute as a whole, reading each word in context rather than in isolation, and unless a different definition is supplied by the legislature, we assume the words chosen have their plain and ordinary meaning. *See City of Rockwall v. Hughes, 246 S.W.3d 621, 625-26 (Tex. 2008)*. Our analysis is informed by the presumption that "the entire statute is intended to be effective" and that "a just and reasonable result is **[*50]** intended." *See Tex. Gov't Code § 311.021(2)*, *(3)*; *Shook v. Walden, 304 S.W.3d 910, 917 (Tex. App.—Austin 2010, pet. denied)*. Only when the statutory text is ambiguous "do we resort to rules of construction or extrinsic aids."[3] *Shook, 304 S.W.3d at 917* (internal **[**10]** quotations omitted); *see also Combs v. Metropolitan Life Ins. Co., 298 S.W.3d 793, 796-97 (Tex. App.—Austin 2009, pet. denied)*.

## DISCUSSION

The Comptroller raises four issues on appeal, which we group into the following two categories. First, the Comptroller asserts that NES provides only services, and therefore its expenses do not qualify for a cost-of-goods-sold deduction. Second, the Comptroller argues that NES's payments to its subcontractors do not constitute "flow-through funds" that can be excluded from total revenue because Newpark's contracts with its customers did not require Newpark or NES to use those subcontractors.

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[3] The parties dispute whether the cost-of-goods-sold deduction is "an imposition of a tax rather than an exemption," which affects whether the tax is strictly construed in favor of or against the taxpayer. *See Upjohn Co. v. Rylander, 38 S.W.3d 600, 606 (Tex. App.—Austin 2000, pet. denied)*. However, this rule of construction only applies if the statute is ambiguous. *See id.*

The parties concede that if Newpark can include NES's expenses in its cost-of-goodssold deduction, then the trial court's judgment in Newpark's favor must be affirmed regardless of whether Newpark **[**11]** can also exclude its flow-through payments from total revenue. *See supra* n.2. Therefore, we will address the cost-of-goods-sold issue first because it may be dispositive in this case.[4] *See Carrollton-Farmers Branch Indep. Sch. Dist., 168 S.W.3d at 188* (noting that appellate court will affirm trial court's determination of tax if correct on any legal theory presented); *see also Tex. R. App. P. 47.1* (requiring appellate courts to hand down opinions that are as short as possible while addressing every issue necessary to disposition).

In its first, third, and fourth issues on appeal, the Comptroller challenges the trial court's determination of Newpark's overall cost-of-goods-sold deduction.[5] Specifically, the Comptroller argues that because NES provides only services, it does not sell any goods for which it could claim a cost-of-goods-sold deduction. Therefore, according to the Comptroller, the trial **[*51]** court erred in including NES's expenses in Newpark's overall cost-of-goods-sold deduction.

As we will discuss, the resolution of this issue involves two separate questions. First, in determining cost of goods sold, do we consider each member of a combined group's business in the context of the combined group's business as a whole, rather than treating each member as if it were a stand-alone company? Second, does NES "furnish[] labor or materials to a project for the construction . . . of real property" such that it can include the cost of that labor or material in its cost of goods sold? *See Tex. Tax Code 171.1012(i)*. Under the facts of this case, we answer yes to both questions, and therefore we affirm the trial court's implied finding that Newpark was entitled to include NES's expenses in its cost-of-goods-sold deduction.

**Do we consider NES's expenses in the context of Newpark's overall sales?**

In its brief, the Comptroller repeatedly emphasizes that NES does not sell any goods in the ordinary course of its business, and therefore it cannot qualify for any cost-of-goods-sold deduction. *See id. § 171.1012(a)(1), (c)—(d)* (defining **[**14]** "good" and listing several costs associated with production and sale of goods that can be deducted). According to Newpark, this argument underscores the fault in the Comptroller's analysis, in that the Comptroller incorrectly views NES as an isolated business rather than as a part of Newpark. The Comptroller's analysis, according to Newpark, is inconsistent with the plain language of the statute.[6]

[4] In addressing the cost-of-goods-sold-deduction issue first, we in no way suggest that the Comptroller or taxable entities are free to determine a general deduction before determining total revenue. However, in this case, the parties concede that if Newpark was entitled to take the cost-of-goods-sold deduction, the trial court's judgment must be affirmed. Therefore, although the cost-of-goods-sold deduction is not a stand-alone theory for determining franchise tax, in this specific case, it is a stand-alone theory for affirming the trial court's judgment. *See Tex. R. App. P. 47.1* (requiring courts of appeals to hand down opinion that is as brief as practicable **[**12]** while addressing every issue necessary for final disposition).

[5] The Comptroller's first, third, and fourth issues relate to whether NES's direct expenses, administrative-overhead costs, and pollution-control costs qualify for the cost-of-goods-sold deduction. *See Tex. Tax Code § 171.1012(c)(7), (f), (i)*. As the Comptroller concedes, if NES's direct expenses are deductible as a cost of goods sold, then NES may also deduct its administrative-overhead and pollution-control costs. As part of its fourth issue, the Comptroller also asserts that there is no evidence to substantiate how much Newpark spent on its pollution-control costs. Even assuming that this argument was not waived as inadequately briefed, *see Tex. R. App. P. 38.1(i)*, **[**13]** we conclude that there is sufficient testimony and documentation in the record to support the trial court's valuation of NES's pollution-control costs.

[6] It is not entirely clear whether the Comptroller actually asserts that NES's activities must be viewed in isolation. In its brief, the Comptroller states that "an entity which would not be eligible for the Cost of Goods Sold deduction if it were an individual taxable entity

We agree with Newpark that the plain language of the statute does not support the Comptroller's interpretation that section 171.1014(e)(1) requires each member's business to be viewed in isolation when determining the member's eligibility to take a cost-of-goods-sold deduction. Section 171.1014 generally governs when and how a combined group files a combined report, and subsection (e) delineates how the combined group calculates its cost-of-goods-sold deduction. This subsection states:

> For purposes of Section 171.101, a combined group that elects to subtract costs of goods sold shall determine the amount by:
>
> (1) *determining the cost of goods sold for each of its members* as provided by Section 171.1012 *as if the member were an individual taxable entity*;
>
> (2) adding the amounts of the cost of goods sold determined under Subdivision (1) together; and
>
> (3) subtracting from the amount determined under **[**16]** Subdivision (2) any cost of goods sold amounts paid from one member of the combined group to another member of the combined group, but only to the extent the corresponding item of **[*52]** total revenue was subtracted under Subsection (c)(3).

*Id*. § 171.1014(e) (emphasis added).

Subsection 171.1014(e) is an accounting mechanism that adds up each member's cost of goods sold while eliminating any "double counting" of intra-group sales or transfers. Given that this provision is effectively a procedural tool, it would be inconsistent to treat subsection 171.1014(e)(1) as an additional substantive limitation that would require each member's business activity to be viewed in complete isolation from the combined group. *Cf.* *Sergeant Enters., Inc. v. Strayhorn, 112 S.W.3d 241, 249-50 (Tex. App.—Austin 2003, no pet.)* (noting that procedural tax tools generally do not affect vested rights of what can be taxed).

This conclusion is directly supported by subsection 171.1014(d-1), which states that "[a] member of a combined group may claim as costs of goods sold those costs that qualify under Section 171.1012 if the goods for which the costs are incurred are owned by another member of the combined group." As **[**17]** this provision indicates, a member that does not sell any goods itself may nevertheless deduct as cost of goods sold those expenses it incurs to sell goods owned by another member of the combined group. It would be entirely inconsistent to treat individual members as isolated entities under subsection (e)(1) but nevertheless allow them to deduct their costs for selling goods that are owned by other members of the combined group.

Finally, the overall structure of section 171.1014 supports the conclusion that when determining the franchise tax of a combined group, we consider the group as whole, not each member in isolation. *See* City of Rockwall, 246 S.W.3d at 625-26 (noting that courts consider statute as a whole and read words in context, not in isolation). As subsection 171.1014(b) clearly states, a "combined group is a single taxable entity for purposes of the

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must calculate its Cost of Goods Sold deduction as zero." This language could be read to support Newpark's argument that the Comptroller attempts to look at NES—and by extension all subsidiaries—as if it were a stand-alone business, completely separate from its parent company. However, the Comptroller also argues that the analysis would be the same even if NES were part of the subsidiary that sold drilling mud because NES's activities are still only services. Thus, it is unclear whether the Comptroller actually attempts **[**15]** to analyze NES in isolation. Nevertheless, because resolution of this issue is fundamental to our disposition of this case, we will address Newpark's argument that, when determining NES's cost-of-goods-sold deduction, NES's activities must be considered in the context of Newpark's overall business.

application of the [franchise tax]." Furthermore, subsection 171.1014(d) requires a combined group to choose to deduct either cost of goods sold or compensation "for all its members," thereby indicating that the franchise tax is intended to apply to all members of a combined group as if they were a single taxpayer. *See also* Tex. Tax Code §§ 171.1014(h) **[**18]** (requiring members of combined group to use same accounting period for determining margin and apportionment), 171.1014(i) (making each member jointly and severally liable for tax owed by combined group). It would be inconsistent with this framework to consider a combined group as a single taxable entity, require each member to take the same general deduction, but nevertheless treat each member as an isolated entity for purposes of determining eligibility to take the cost-of-goods-sold deduction. *Compare id.* § 171.1014(b), (d)—(d-1), *with id.* § 171.1014(e)(1). This conclusion would lead to the absurd result that a company that had no subsidiaries could take all costs-of-goods-sold deductions allowable under section 171.1012, but if that same company created subsidiaries it could potentially lose substantial cost-of-goods-sold deductions because each subsidiary might not sell goods in the ordinary course of its business.

Therefore, reading section 171.1014 as a whole, we agree with Newpark that each member's cost-of-goods-sold deduction must be determined by considering the member's expenses in the context of the combined group's overall business. To the extent the Comptroller asserts **[**19]** that section 171.1014(e)(1) requires us to look at NES in complete isolation, that interpretation is inconsistent with the statute. Thus, under the plain language of section 171.1014, we determine NES's eligibility to take a cost-of-goods-sold **[*53]** deduction within the context of Newpark's overall business.

**Do NES's expenses qualify as costs of goods sold under section 171.1012(i)?**

In its primary argument on appeal, the Comptroller asserts that Newpark cannot include NES's expenses in its cost-of-goods-sold deduction. Specifically, the Comptroller claims that NES's removal and disposal of waste material is a "service" within the meaning of section 171.1012, and therefore NES does not sell a good for which the cost-of-goods-sold deduction could apply. *See id.* § 171.1012(a)(3)(B)(i) (excluding "services" from definition of tangible personal property). In its response, Newpark asserts that NES furnishes labor to projects for the construction and improvement of real property, and therefore Newpark is entitled to take a cost-of-goods-sold deduction for these expenses under section 171.1012(i). We begin our analysis of this issue with a brief overview of the cost-of-goods-sold deduction, focusing **[**20]** on those sections relevant to this appeal.

For purposes of the cost-of-goods-sold deduction, a "good" is "real or tangible property sold in the ordinary course of business of a taxable entity." *Id.* § 171.1012(a)(1). "Tangible personal property" is further defined as "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner," as well as various films, sound recordings, and other forms of property not at issue in this case. *Id.* § 171.1012(a)(3)(A)(i)—(iii). However, "services" are specifically excluded from the definition of tangible personal property. *Id.* § 171.1012(a)(3)(B)(i)—(ii).

A taxable entity that elects to take the cost-of-goods-sold deduction may deduct "all direct costs of acquiring or producing the goods," including labor, materials, handling, depreciation, and other sunk costs related to production. *Id.* § 171.1012(c)—(d). A taxable entity may also deduct up to 4% of its indirect or administrative overhead costs—such as legal, security, and accounting services—provided that it can demonstrate those costs "are allocable to the acquisition or production of goods." *Id.* § 171.1012(f). However, a taxable entity **[**21]** generally cannot include costs related to the actual sale of goods—such as distribution, advertising, rehandling, or bidding expenses—in its cost-of-goods-sold deduction. *See id.* § 171.1012(e).

Finally, subsection 171.1012(i) creates a restriction—and potential expansion—of which entities can take a cost-of-goods-sold deduction. It states, in relevant part:

> 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. . . . A taxable entity *furnishing labor or materials to a project* for the construction, improvement, remodeling, repair, or industrial maintenance . . . of real property is considered to be an owner of that labor or materials and may include the costs, *as allowed by this section*, in the computation of cost of goods sold.

*Id.* § 171.1012(i) (emphasis added). With this statutory framework in mind, we now consider the facts of this case.

Newpark concedes that NES's disposal of waste does not qualify as either real or tangible personal property, and thus NES itself does not sell a "good" within the meaning of the franchise tax. *See id.* § 171.1012(a)(1). However, as discussed above, we do not consider NES in **[**22]** isolation, but rather determine whether NES's expenses qualify as a deductible cost of selling some Newpark good. *See id.* § 171.1014(d-1). Within that context, Newpark asserts that NES's expenses are part of the overall labor and materials that Newpark furnishes to the drilling of oil **[*54]** and gas wells, which the Comptroller does not dispute constitutes a project for the construction and improvement of real property. *See id.* § 171.1012(i). Based on the record, it appears that NES's expenses do not fit into any of the specified costs that can be deducted under subsections (c), (d), or (f).[7] Therefore, if NES's expenses qualify for a cost-of-goods-sold deduction, they must qualify under section 171.1012(i).

The Comptroller asserts that NES's removal and disposal of **[**23]** drilling mud is purely a service and does not constitute labor furnished to a project for the construction or improvement of real property. The terms "labor" and "service" are not defined in chapter 171 or in the Tax Code. Nevertheless, the Comptroller contends that the terms must have different meanings because section 171.1011(g)(3) lists "services" and "labor" as separate activities that can be related to the improvement of real property. *See id.* § 171.1011(g)(3) (noting that taxpayer may exclude flow-through payments for "services, labor, or materials in connection with . . . design, construction, remodeling . . . on real property"). This use of separate terms, according to the Comptroller, indicates that the legislature understood services to mean something distinct from labor with respect to the construction of real property.

Although we agree that the separate listing of services and labor in section 171.1011(g)(3) indicates that they encompass different concepts, the fact that the terms are listed separately does not mean they are mutually exclusive. *See* *Matagorda Cnty. Appraisal Dist. v. Coastal Liquids Partners, L.P., 165 S.W.3d*

[7] The removal and disposal of waste from the drilling site is not an aspect of the acquisition or production of drilling mud, nor is it a result of deterioration, spoliage, or other sunk cost associated with the production of drilling mud. *See* Tex. Tax Code § 171.1012(c)—(d). In addition, NES's removal and disposal of waste does not constitute an indirect or administrative overhead cost of producing a good. *See id.* § 171.1012(f).

*329, 334-35 (Tex. 2005)* (noting that categories **[**24]** listed separately in statute can still overlap). Furthermore, the fact that *section 171.1011(g)(3)* indicates that labor and services have distinct meanings does not provide us with clear guidance as to what that distinction is. Neither term is defined in the statute, and the ordinary definitions of labor and services substantially overlap such that both definitions tend to refer to the words interchangeably.[8] *See City of Rockwall, 246 S.W.3d at 625-26* (noting that courts assume undefined terms have ordinary meaning). Webster's Dictionary does offer one arguably pertinent definition of services, explaining it to mean "useful labor that does not produce a tangible commodity," noting that "railroads, telephone companies, and physicians perform services although they produce no goods." *See* Webster's Third New International Dictionary 2075 (Phillip Gove Ed. 2002). However, even assuming we could reconcile that definition with *section 171.1011(g)(3)*'s reference to "services . . . in connection with the actual or proposed design, construction, . . . of real property," the same question still remains—does NES furnish "labor" to a project for the construction of real property? In order to **[*55]** answer **[**25]** that question, we must determine *section 171.1012(i)*'s function.

*Function of section 171.1012(i)*

The function of *section 171.1012(i)* must be determined within the context of the *section 171.1012* generally. *See City of Rockwall, 246 S.W.3d at 625-26* (noting that courts consider entire statute and put words in context). We will primarily consider the consequences of the various proposed constructions, presuming that the legislature intended the entire statute to be effective and to achieve "a just and reasonable result." *See Tex. Gov't Code §§ 311.021(3), 311.023(5)*.

Generally, *section 171.1012(i)* operates as a broad limitation on which entities can claim the cost-of-goods-sold deduction, restricting it to those that actually own **[**26]** the goods they sell. *See Tex. Tax Code § 171.1012(i)*. However, the section then provides a general exception to this rule—stating that those that furnish labor or materials to certain projects related to real property are "considered to be an owner of that labor or materials and may include the costs, *as allowed by this section*, in the computation of cost of goods sold." *See id.* (emphasis added). It is not entirely clear from the structure of this subsection what the legislature was trying to accomplish. Did it mean that, in the context of improving real property, a party furnishing labor does not need to sell a separate good to qualify for the cost-of-goods-sold deduction? If so, can those entities that furnish labor to the improvement of real property deduct all expenses related to their supply of labor as a cost of goods sold? Can multiple taxpayers qualify as furnishing the same labor, thereby allowing multiple deductions for the same expense?

The Comptroller asserts that "[t]he purpose of *Section 171.1012(i)* is to allow construction companies and contractors . . . to act like they are the owner of those materials and labor." Otherwise, the Comptroller notes, "construction companies **[**27]** and contractors could not take the Cost of Goods Sold deduction because they do not own the finished product." Although this is merely a litigation position and not a formal interpretation, it is generally consistent with Newpark's explanation of the statute and a common-sense understanding that many contractors and subcontractors that improve or maintain real property do not

[8] Webster's defines "labor" as the "expenditure of physical or mental effort especially when fatiguing, difficult, or compulsory," while "service" is defined as "the performance of work commanded or paid for by another." *See* Webster's Third New International Dictionary 1259, 2075 (Phillip Gove Ed. 2002). Thus, both labor and services are generally work done for another, with labor potentially including an additional expenditure of either physical or mental effort.

actually own or sell the property. Given that real property itself is a "good" within the meaning of section 171.1012, but that many of the businesses that incur costs to improve or maintain real property never sell that good, the legislature could have reasonably intended section 171.1012(i) to allow those same companies to deduct their costs as if they were a cost of goods sold.

Otherwise, section 171.1012(i)'s provision making the party that furnishes labor the "owner" of that labor would be meaningless because, regardless of whether a contractor owned the labor it supplied, the contractor could not deduct the cost of supplying that labor unless it also sold the real property or some other tangible personal property in the ordinary course of its business. *See* Tex. Tax Code § 171.1012(i); *see also* Tex. Gov't Code § 311.021(2) **[**28]** (noting that courts presume entire statute intended to be effective). Furthermore, it would make the classification of real property as a good relatively ineffectual because a potentially large percentage of taxable entities that incur costs to develop or maintain real property would never be able to deduct those costs as a cost of goods sold. Therefore, we conclude that when viewed in the context of section 171.1012, subsection (i) means that the party that supplies labor or materials to the construction, improvement, remodeling, repair, or industrial maintenance of **[*56]** real property can deduct its labor or material expenses as a cost of goods sold, assuming those expenses would qualify as the cost of selling real property. *See* Tex. Tax Code § 171.1012(i) (permitting deduction of labor and materials costs "as allowed by this section"). Having determined the function of section 171.1012(i), we can more accurately determine what constitutes labor furnished for the improvement of real property.

*Meaning of "labor" within the context of section 171.1012*

Given our conclusion that section 171.1012(i) is designed to allow the party that furnishes labor for the improvement of real property to deduct **[**29]** that cost as if it sold the property, there is no reason to believe that "labor" under subsection 171.1012(i) means anything different than labor under section 171.1012 generally. *See* Sheshunoff v. Sheshunoff, 172 S.W.3d 686, 692 (Tex. App.—Austin 2005, pet. denied) (noting that courts presume that same terms used in same connection in different statutes have same meaning). Generally, a taxable entity may deduct "all direct costs of acquiring or producing" goods, including "labor costs." *See* Tex. Tax Code § 171.1012(c)(1).

"Labor" is a broad term that encompasses a wide range of activities, including "expenditure of physical or mental effort especially when fatiguing, difficult, or compulsory." Webster's Third New International Dictionary 1259, 2075 (Phillip Gove Ed. 2002). None of the surrounding statutory text indicates that labor has a more limited meaning than its common definition. *Cf.* Railroad Comm'n of Tex. v. Texas Citizens for a Safe Future & Clean Water, 336 S.W.3d 619, 628 (Tex. 2011) ("[W]e have warned against expansively interpreting broad language where it is immediately preceded by narrow and specific terms."). Therefore, we presume that the legislature intended to allow **[**30]** taxable entities to deduct a wide range of labor expenses.[9] *See* Texas Dep't Pub. Safety v. Abbott, 310 S.W.3d 670, 675 (Tex. App.—Austin 2010, no pet.)

[9] Because "labor" within the context of section 171.1012(i) can be given a clear and definite meaning based solely on the plain language of the statute, we conclude that the statute is not ambiguous. *See* Entergy Gulf States, Inc. v. Summers, 282 S.W.3d 433, 437 (Tex. 2008). Therefore, we do not reach whether the cost-of-goods-sold deduction operates as an imposition of a tax rather than a tax exemption. *See* Upjohn Co. v. Rylander, 38 S.W.3d 600, 606 (Tex. App.—Austin 2000, pet. denied) (noting that these presumptions only considered when tax statute is ambiguous). Similarly, we need not defer to the Comptroller's interpretation of the statute. *Id.*

(noting courts assume broad statutory terms have broad meaning).

We look to the facts of this case to determine whether NES's services, put in the context of Newpark's overall services, qualify as labor for the construction or improvement of real property. It is undisputed that the drilling and construction of oil and gas wells qualifies as construction or improvement to real property. Furthermore, **[**31]** it is undisputed that the injection and removal of drilling mud qualifies as labor and materials that are furnished for the construction of oil and gas wells. Therefore, the only question is whether NES's subsequent transport and disposal of the used drilling mud and other waste material is part of the labor involved in the drilling process.

The Comptroller asserts that NES's activities are akin to a garbage collector that picks up trash cans on the street corner and transports the trash to the local landfill. These activities, according to the Comptroller, are clearly a service and not labor supplied for the improvement of real **[*57]** property. While the Comptroller's hypothetical may be true as far as it goes, it seems that Newpark's activity in the record before us is more analogous to a demolition company that tears down a preexisting structure and then removes the resulting debris so that new construction can begin. It would be irrational to conclude that the demolition of the old structure is labor furnished for the construction or improvement of real property but that the actual removal and disposal of the resulting debris is a service that is not part of the construction process. After **[**32]** all, demolition without disposal would be pointless in this situation.

Similarly, it is difficult to view NES's disposal of waste material as though it were not an essential and direct component of the drilling process. Given that similar costs for scrap material and pollution control devices are deductible as costs of producing tangible personal property, it follows that such expenses should also be deductible for the improvement or maintenance of real property. *See* Tex. Tax Code § 171.1012(c)(7)—(8), (d)(3). There was testimony at trial that the waste material was an inescapable byproduct of drilling, that removal and disposal of this waste material was essential to continue drilling, and that without this disposal the drilling process would come to an immediate halt. Based on this testimony, the trial court could have reasonably concluded that the removal and disposal of this waste material was labor furnished to a project for the construction and improvement of real property.

Admittedly, other cases may present a close issue as to when labor is too far removed from the construction, improvement, remodeling, repair, or industrial maintenance of real property to qualify for the cost-of-goods-sold **[**33]** deduction under section 171.1012(i). In this case, however, we conclude that the record supports the trial court's implied finding that NES furnishes labor to a project for the construction or improvement of real property. Therefore, the trial court did not err in including NES's expenses within Newpark's overall cost-of-goods-sold deduction. We overrule the Comptroller's first, third, and fourth appellate issues.

## CONCLUSION

Having concluded that Newpark was entitled to include NES's expenses in its overall cost-of-goods-sold deduction, we need not determine whether Newpark could also exclude flow-through payments to subcontractors from NES's total revenue. *See* Carrollton-Farmers Branch Indep. Sch. Dist., 168 S.W.3d at 188 (noting that appellate courts affirm trial court's determination of tax if correct on any legal theory presented); *see also* Tex. R. App. P. 47.1. We affirm the judgment of the trial court.

Scott K. Field, Justice

Before Chief Justice Jones, Justices Pemberton and Field

Concurring Opinion by Chief Justice Jones

Affirmed

Filed: December 31, 2013

**Concur by:** J. Woodfin Jones

## Concur

### CONCURRING OPINION

Although I concur in the judgment, I write separately because I believe the franchise-tax statute **[**34]** obligates us, as a threshold matter, to calculate Newpark's total revenue. In order to do that, it is necessary that we address whether Newpark's flow-through payments to subcontractors should be excluded from total revenue. *See* Tex. Tax Code § 171.1011(g)(3) (specifying that "taxable entity *shall exclude from its total revenue*" funds burdened by contractual obligation to be "distributed to other entities"); *id*. § 171.1011(j) (prohibiting funds excluded from total revenue from being included in determination of cost-of-goods-sold or compensation subtractions); *cf*. Fed. Rev. Rul. 59-92 (Jan. 1, 1959) **[*58]** (setting forth principle that "where a taxpayer receives funds burdened by an obligation to be expended for a specific purpose and earmarked for such purpose, the funds so held do not constitute gain or income to the taxpayer"). Although not directly stated, the majority opinion apparently avoids considering the total-revenue issue on the basis that it would be "advisory" to consider the matter in light of the parties' concession that the result would be the same in this case regardless of whether the disputed revenue were actually excluded from total revenue (in whole or part).[1] I believe **[**35]** this approach disregards the order of operations dictated by the statute.

"The distinctive feature of an advisory opinion is that it decides an abstract question of law without binding the parties." *Texas Ass'n of Bus. v. Texas Air Control Bd., 852 S.W.2d 440, 444 (Tex. 1993)*; *see also* *State Bar of Tex. v. Gomez, 891 S.W.2d 243, 245 (Tex. 1994)* (advisory opinion is one not binding on parties); *Black's Law Dictionary* 1125 (9th ed. 2009) (defining "advisory opinion" as "[a] nonbinding statement by a court of its interpretation of the law on a matter submitted for that purpose"). Under the plain language of the franchise-tax statute, matters implicating total revenue are necessarily antecedent to the COGS subtraction issue as presented in this case. Moreover, the issue of excluding **[**36]** flow-through payments from total revenue is implicated in this case, and a decision interpreting that provision would indisputably bind the parties. This is not a case in which the amount of funds to be included in Newpark's total-revenue calculation is undisputed. To the contrary, the parties hotly contest what portion of the funds Newpark received is actually revenue that is taxable in the first instance. Newpark contends that, by contract, it is merely a conduit for some funds paid to subcontractors, while the Comptroller maintains that Newpark does not meet the statutory requirements for excluding subcontractor payments from total revenue. There is nothing hypothetical or abstract about this issue. Accordingly, although I agree with the result in this case, I fear that the majority opinion may be read to suggest that taxpayers

[1] While the appellants assert that "[t]he resulting tax liability does not differ whether the subcontractor payments are treated as a revenue exclusion or part of a deduction," Newpark observes that the tax refund would be different depending on how the disputed issues are actually resolved except that the amount of any tax refund would be capped by the amount Newpark actually paid under protest, plus interest.

or taxing authorities can calculate revenue and expenses in any order that is convenient for them in derogation of express statutory language. *Cf.* *Bell Helicopter Textron, Inc. v. Combs, No. 03-10-00764-CV, 2011 Tex. App. LEXIS 10232, 2011 WL 6938491, at *1-5 (Tex. App.—Austin Dec. 29, 2011)* (mem. op.) (dispute concerning tax refund ignored plain language **[**37]** of statute that dictated sequence giving rise to accrual of tax obligations, penalties on underpayments, and interest on overpayments); *Carrollton-Farmers Branch Indep. Sch. Dist. v. JPD, Inc., 168 S.W.3d 184, 187-88 (Tex. App.—Dallas 2005, no pet.)* (in denying refund of portion of penalties and interest calculated on incorrect appraised value, taxing authority failed to adhere to order of operations dictated by taxing scheme).

Under the franchise-tax statute, franchise taxes are assessed against each respective entity's "taxable margin." *Tax Code § 171.002(a)*, *(b)*. There are four methods of computing taxable margin, and those methods are characterized by the mutually exclusive subtractions authorized to be made from total revenue depending on the method selected: no subtractions under the E-Z computation method (*Tax Code § 171.1016*), **[*59]** a 30% general subtraction (*Tax Code § 171.101(a)(1)(A)*), a subtraction for cost of goods sold (*Tax Code § 171.101 (a)(1)(B)(ii)(a)*), or a subtraction for compensation (*Tax Code § 171.101(a)(1)(B)(ii)(b)*).[2] Taxable margin is the figure on which an entity's franchise-tax obligation is based, and all four methods of computing taxable margin require that total **[**38]** revenue be calculated as the first step. Once total revenue is properly calculated, the taxpayer may elect to make one of three general subtractions along with other adjustments, as applicable, before applying the tax rate, which is .5% for taxable entities primarily engaged in retail or wholesale trade and 1% for all others. *See, e.g.*, *Tax Code §§ 171.0021*, *.106* (apportionment of margin to this state), *.107* (deduction of cost of solar energy device), *.108* (deduction of cost of clean coal project). In the alternative, if the taxpayer has less than $10 million in total revenue, the taxpayer may elect a lower tax rate of .575% in lieu of making any subtractions or adjustments other than apportionment of revenue between in-state and out-of-state business. *See id.* *§§ 171.1016*, *.106*. The tax obligation is then determined by multiplying taxable margin by the applicable tax rate and subtracting any credits or discounts. *See id.* *§ 171.0021* (discounts for small businesses). Taxpayers can choose any method of determining taxable margin that they qualify for and that results in the lowest tax obligation. *See id.* *§ 171.101(a)* ("The taxable margin of a taxable entity is computed by . . . determining **[**39]** the taxable entity's margin, which is the lesser of [30% cap method, COGS subtraction method, or compensation subtraction method]."), *.1016* (allowing certain taxpayers to elect to pay lower franchise-tax rate under E-Z computation method). According to the plain language of the statute, the amount of total revenue must be the same for all four methods of calculating taxable margin.

Although the majority opinion generally acknowledges the formula prescribed by the statute, including that the COGS subtraction must come after total revenue has been calculated, it does not further address this predicate legal issue. Along the way, the opinion states that the taxpayer or taxing entity may choose, at its discretion, whether to exclude sums from total revenue **[**40]** or

[2] The E-Z computation method offers a potentially lower tax rate of 0.575 percent for taxpayers "whose total revenue from its entire business is not more than $10 million." *Tax Code § 171.1016*. However, a taxpayer electing this method "may not take a credit, deduction, or other adjustment" other than apportioning its gross receipts attributable to business in this state. *Id.*; *see also id.* ***§ 171.106*** (apportionment of margin to this state).

subtract them as part of the COGS or compensation subtraction and that the trial court in the present case therefore "*must* have concluded that Newpark was entitled to claim [all of] NES's expenses . . . in Newpark's overall cost-of-goods-sold deduction." *See Combs v. Newpark*, __ S.W.3d __, slip op. at 6 (emphasis added). The opinion also states that "*if* a taxable entity excludes flow-through payments to subcontractors from its total revenue, it cannot claim those same payments in its cost-of-goods-sold deduction." *Id*. at 5 n.2 (emphasis added); *see also id*. at 15 (phrasing revenue exclusion in discretionary terms while statute uses mandatory terms). The majority opinion also presumes, without analysis, that funds that are not considered to be part of the taxpayer's total revenue—i.e., funds that were not income or gain because the taxpayer was contractually obligated to hand those funds over to a third party—could **[**41]** nevertheless be properly considered and treated as the taxpayer's expenses. In my opinion, **[*60]** these statements are inconsistent with the statute's plain language because they treat the exclusion of flow-through payments from total revenue as discretionary rather than mandatory.

This is not just a theoretical distinction with no potential substantive impact. With respect to the COGS subtraction specifically, there is a 4% cap on the inclusion of indirect and administrative expenses along with a requirement that the total of such expenses be allocable to the acquisition or production of goods. *See* Tax Code § 171.1012(f). Ignoring the statutory order of operations creates a potential that the total indirect and administrative expenses could be inflated, resulting in an inflation of the amounts subject to the cap. It is difficult to conceptualize all the possible permutations of revenue, expenses, and allocations that could be affected by the failure to follow the statutory order of operations. Although there appears to be no actual impact to the bottom line in this case, that does not justify proceeding in a manner different from what the statute requires.[3]

The COGS subtraction is not an "alternative legal theory" but is an *element* of Newpark's chosen method of computing taxable margin; it is not itself a separate theory of computing tax liability. Based on the wording of the franchise-tax statute, any determination of the amount of tax owed necessarily requires a determination of whether the flow-through funds are to be subtracted from total revenue—either they are excluded in whole or in part or they are not. Only if it is determined that they should not be subtracted from total revenue is it proper to consider whether such funds might be otherwise deductible. The relevant legal theory at issue here is the method of determining taxable margin using the COGS subtraction; while the amount of the COGS subtraction is an essential element of that theory, so is the antecedent calculation of total revenue.

I am concerned that we are ignoring the plain language of a statute simply because the parties say we can do so without impacting the result in a particular case.

J. **[**43]** Woodfin Jones, Chief Justice

Before Chief Justice Jones, Justices Pemberton and Field

Filed: December 31, 2013

[3] Newpark asserts in its brief that **[**42]** its tax liability would in fact vary depending on how the issues in this case are resolved, but any refund in this action would be capped at the amount of tax paid under protest.

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**Appellate History:**Requested

**Citing Decisions:**None Applied

**Other Citing Sources:**None Applied

**Table Of Authorities:**Not Requested

***Shepard's*®:** **Combs v. Newpark Res., Inc.** 422 S.W.3d 46,2013 Tex. App. LEXIS 15455: (Tex. App. Austin 2013)

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| No subsequent appellate history |

## Appellate History (1)

1. **Citation you *Shepardized*™**
**Combs v. Newpark Res., Inc.**, 422 S.W.3d 46, 2013 Tex. App. LEXIS 15455

**Court:** Tex. App. Austin | **Date:** 2013

# Combs v. Roark Amusement & Vending, L.P.

Supreme Court of Texas

October 15, 2012, Argued; March 8, 2013, Opinion Delivered

NO. 11-0261

**Reporter**

422 S.W.3d 632; 2013 Tex. LEXIS 179; 56 Tex. Sup. J. 368; 2013 WL 855737

SUSAN COMBS, COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS, AND , ATTORNEY GENERAL OF THE STATE OF TEXAS, PETITIONERS, v. ROARK AMUSEMENT & VENDING, L.P., RESPONDENT

**Subsequent History:** Released for Publication April 12, 2013.

**Prior History: [**1]** ON PETITION FOR REVIEW FROM THE COURT OF APPEALS FOR THE THIRD DISTRICT OF TEXAS.
*Roark Amusement & Vending, L.P. v. Combs, 2011 Tex. App. LEXIS 632 (Tex. App. Austin, Jan. 26, 2011)*

## Case Summary

### Procedural Posture

The Court of Appeals for the Third District of Texas held respondent taxpayer's toy prizes were exempt from the sales tax under the Tax Code's sale-for-resale exemption. Petitioner Comptroller of Public Accounts appealed.

### Overview

The supreme court agreed with the taxpayer that under *Tex. Tax Code Ann. §§ 151.0028* and *151.0101*, it qualified for a sales-tax exemption on the plush toys that filled its crane machines. The toys were subject to the sale-for-resale exemption because under *Tex. Tax Code Ann. § 151.006(3)*, the toys were tangible personal property acquired by the taxpayer for the purpose of transferring the toys as an integral part of a taxable service. The performance of an amusement service through a coin-operated machine was a taxable service. *Tex. Tax Code Ann. § 151.302* did not suggest that every single customer had to walk away with a toy. The transfer occurred and was integral to the success of the game as an amusement service. The Comptroller could not through rulemaking impose taxes that were not due under the Tax Code.

### Outcome

The judgment was affirmed.

**Counsel:** For Ron Beal, Amicus Curiae: Ron Beal, Professor & Attorney at Law, Waco TX.

For Susan Combs, Petitioner: Daniel T. Hodge, First Asst. Attorney General, Austin TX; David C. Mattax, Director of Defense Litigation, Office of the Attorney General, Austin TX; Greg W. Abbott, Attorney General of Texas, Austin TX; Jeff M. Graham, William J. "Bill" Cobb III., Office of the Attorney General, Austin TX; Kevin D. Van Oort, Deputy Chief - Financial & Tax Litigation Div., Austin TX; Marc Alan Barenblat, Assistant Attorney General, Financial and Tax Litigation Div., Austin TX; Ronald R. Del Vento, Assistant Attorney General, Chief, Bankruptcy & Collections Div., Austin TX.

For Roark Amusement & Vending L.P., Respondent: Amanda Garrett Taylor, Hohmann Taube & Summers, L.L.P., Austin TX; Amanda Marie Traphagan, James F. Martens, Martens Seay & Todd, G.P., Austin TX.

**Judges:** JUSTICE WILLETT delivered the opinion of the Court. Don R. Willett, Justice.

**Opinion by:** Don R. Willett

## Opinion

**[*634]** JUSTICE WILLETT delivered the opinion of the Court.

Roark Amusement & Vending, L.P. brought this tax-refund suit against the Comptroller of Public Accounts, seeking to recoup **[**2]** sales taxes it paid on "plush toy" prizes used to stock its coin-operated amusement machines. The court of appeals held the toys were exempt from sales tax under the Tax Code's sale-for-resale exemption. We agree and affirm the court of appeals' judgment.

### I. Factual and Procedural Background

The facts are undisputed, having been established below in a stipulation of facts or in uncontested affidavits. Roark owns and leases coin-operated amusement crane machines that are found in supermarkets, restaurants, and shopping malls throughout Texas. Customers aim to win plush toys by using a joystick to maneuver a mechanical claw to grab the toys and drop them into a prize chute. Successful customers keep the prizes, and eventually all the toys become property of customers in this manner (except for those lost, stolen, or damaged).

Roark sought a refund of the sales taxes it paid on the toys it purchased to stock its machines for the period October 1, 2000 through February 29, 2004.[1] It argued that the toys were exempt under the sale-for-resale exemption discussed below. The Comptroller disputed that the exemption applied.

The trial court granted the Comptroller's motion for summary judgment and denied Roark's refund request. The court of appeals reversed, concluding the toys were exempt, and remanded the case to the trial court for a determination of the refund amount due Roark.[2] We granted the Comptroller's petition for review.

### II. Discussion

Our decision turns on the interplay of various Tax Code provisions found in chapter 151.

• The Sales Tax Generally: *Section 151.051(a)* imposes a sales tax "on each sale of a taxable item in this state." "'Taxable item' means tangible personal property and taxable services."[3] The plush toys are "tangible personal property," a term that captures "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other **[**4]** manner."[4] A "taxable service" refers to certain services enumerated in *section 151.0101*, including "amusement services," which covers "the provision of amusement, entertainment, or recreation."[5]

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[1] The parties stipulated that Roark pays an occupation tax on the machines **[**3]** themselves under chapter 2153 of the Occupations Code. *See* *Tex. Occ. Code § 2153.401*. The Tax Code has since been amended in a manner that is not relevant to the time period in issue in this case, but may be relevant to the legal issues raised. *See* Act of June 28, 2011, 82d Leg., 1st C.S., ch. 4, § 12.01, 2011 Tex. Gen. Laws 5263 (adding new *subsection (c) to Tex. Tax Code § 151.006*).

[2] _ S.W.3d _, _.

[3] *Tex. Tax Code § 151.010*.

[4] *Id.* *§ 151.009*.

[5] *Id.* *§ 151.0028*.

**[*635]** • The Sale-For-Resale Exemption: Provisions found in subchapter H set out numerous exemptions. *Section 151.302(a)* states: "The sale for resale of a taxable item is exempted from the taxes imposed by this chapter." This provision is qualified by *section 151.302(b)*, which states: "Tangible personal property used to perform a taxable service is not considered resold unless the care, custody, and control of the tangible personal property is transferred to the purchaser of the service." A "sale for resale" is further refined in *section 151.006*. *Section 151.006(a)(3)* provides that a sale for resale includes a sale of "tangible personal property to a purchaser who acquires the property for the purpose of transferring it . . . as an integral part of a taxable service."

• Coin-Operated Machines Specifically: *Section 151.335* creates an exemption for coin-operated machines. *Section 151.335(a)* states: "Amusement and personal services provided through **[**5]** coin-operated machines that are operated by the consumer are exempt from the taxes imposed by this chapter." However, *section 151.335(b)* states: "This section does not apply to the sale of tangible personal property . . . through the use of a coin-operated machine."

When construing a statute, our chief objective is effectuating the Legislature's intent, and ordinarily, the truest manifestation of what lawmakers intended is what they enacted.[6] This voted-on language is what constitutes the law, and when a statute's words are unambiguous and yield but one interpretation, "the judge's inquiry is at an end."[7] We give such statutes their plain meaning without resort to rules of construction or extrinsic aids.[8] On the other hand, "[i]f a statute is vague or ambiguous, we defer to the agency's interpretation unless it is plainly erroneous or inconsistent with the language of the statute."[9]

We agree with Roark that under a plain-meaning review of the relevant statutes, it qualifies for a sales-tax exemption on the plush toys that fill its crane machines. The machines provide a taxable amusement service under *sections 151.0028* and *151.0101*, in that they provide for "amusement, entertainment, or recreation" under *section 151.0028*. The toys are subject to the sale-for-resale exemption because under *section 151.006(3)*, the toys are "tangible personal property" acquired by Roark "for the purpose of transferring" the toys "as an integral part of a taxable service." Indeed, the toys are more than integral to the machines' amusement service—they are *indispensable*. There would be no point (or profit) to the game—and thus no game—if customers had no chance of winning a toy. Roark contends in its principal brief, and the Comptroller does not dispute, that "[c]ustomers would not pay to play an empty machine (i.e., **[**7]** they would not pay to move a crane's claw around an empty glass case), nor would they pay to play if the machines contained toys that were impossible to retrieve."

**[*636]** The Comptroller makes two arguments that are incompatible with the statutory text, and thus unpersuasive.[10]

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[6] *First Am. Title Ins. Co. v. Combs, 258 S.W.3d 627, 632 (Tex. 2008)*.

[7] *Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 651-52 (Tex. 2006)*.

[8] *Tex. Lottery Comm'n v. First State Bank of DeQueen, 325 S.W.3d 628, 635, 637 (Tex. 2010)* (branding such reliance "improper," because "[w]hen a statute's language **[**6]** is clear and unambiguous, it is inappropriate to resort to rules of construction or extrinsic aids to construe the language" (quoting *City of Rockwall v. Hughes, 246 S.W.3d 621, 626 (Tex. 2008))*.

[9] *Tex. Dep't of Ins. v. Am. Nat'l Ins. Co., 410 S.W.3d 843, __, 2012 Tex. LEXIS 420 (Tex. 2012)*.

[10] *See* *First Am. Title Ins. Co., 258 S.W.3d at 632* (deferring to Comptroller's interpretation "so long as the construction is reasonable and does not contradict the plain language of the statute"

### A. Do Roark's Crane Machines Provide a "Taxable Service"?

The Comptroller argues that the sale-for-resale exemption fails because the amusement service provided by Roark is not a "taxable service" under section 151.006(3). That is, since section 151.335(a) exempts amusement services provided by coin-operated machines, the service here is not taxable. We disagree with this construction, and instead find persuasive the court of appeals' analysis of this issue.

Taxable service is a defined term under chapter 151. If a term is expressly defined by statute we must follow that definition.[11] Section 151.0101 defines "taxable service" to include "amusement services," **[**8]** whether provided by coin-operated machines or otherwise. The fact that section 151.335(a) sets out an *exemption* for amusement services provided by coin-operated machines does not alter the fact that the machines provide a taxable service as defined in section 151.0101. Indeed, there would be no need to provide an exemption for this particular service if it were not a taxable service in the first instance. As noted above, under section 151.010, "taxable item" refers to "tangible personal property and taxable services." Section 151.301, the first provision of subchapter H, which sets out exemptions, provides: "If a *taxable item* is *exempted* from the taxes imposed by this chapter, the sale, storage, use, or other consumption of the item is not subject to the sales tax imposed by Section 151.051 of this code . . ." (emphasis added). This section confirms that under chapter 151 an item exempt from taxation may nevertheless be included in the universe of taxable items.[12] Taxable items in turn include taxable services, and taxable services include amusement services, under the provisions discussed above. Similarly, section 151.005 defines a "sale" or "purchase" to include "the performance **[**9]** of a taxable service . . . or, in the case of an *amusement service* . . . the use of a coin-operated machine" (emphasis added). Again, even though amusement services provided via coin-operated machines are later exempted in section 151.335(a), the definitional language of chapter 151 itself confirms that the performance of an amusement service through a coin-operated machine—the precise situation presented here—is a taxable service. Examining chapter 151 as a cohesive, integrated whole confirms that Roark's construction is the correct one.[13]

### [*637] B. Is the Chance to Win an "Integral Part of a Taxable Service"?

Alternatively, in looking to language in section 151.006(a)(3), requiring that the transfer of toys be an "integral part" of the service provided, the Comptroller argues that the sale-for-resale exemption in section 151.006(3) does not apply unless a toy is conveyed each and

(quoting Tarrant Appraisal Dist. v. Moore, 845 S.W.2d 820, 823 (Tex. 1993))).

[11] *See* Tex. Gov't Code § 311.011(b) ("Words and phrases that have acquired a technical or particular meaning, whether by legislative definition or otherwise, shall be construed accordingly.").

[12] *See also* 7-Eleven, Inc. v. Combs, 311 S.W.3d 676, 690 (Tex.App.—Austin 2010, pet. denied) ("The sale-for-resale statute simply requires that the service to which the transfer of tangible personal property is integral be a *taxable* service—not that it actually *be taxed* in the particular instance in question.").

[13] *See* City of San Antonio v. City of Boerne, 111 S.W.3d 22, 25 (Tex. 2003) ("We determine legislative intent from the entire act and not just its isolated **[**10]** portions. Thus, we read the statute as a whole and interpret it to give effect to every part.") (citations and internal quotation marks omitted); Helena Chem. Co. v. Wilkins, 47 S.W.3d 486, 493 (Tex. 2001) ("Additionally, we must always consider the statute as a whole rather than its isolated provisions. We should not give one provision a meaning out of harmony or inconsistent with other provisions, although it might be susceptible to such a construction standing alone.") (citation omitted). The Comptroller likewise urges the Court to view the Code as a whole, arguing for example in her principal brief that sections 151.006 and 151.302, discussed above, "are necessarily read in tandem," and advocating what she sees as "a reasonable and harmonious implementation of tax code sections 151.006, 151.302, and 151.335."

every time a customer plays the game. **[**11]** The Comptroller urges that *section 151.302(b)* imposes such a requirement by stating that tangible personal property is not considered resold unless the care, custody, and control of the property is "transferred to *the* purchaser of the service." We disagree. These provisions do not impose, either explicitly or implicitly, any such extra-statutory requirement, and we decline to engraft one—revising the statute under the guise of interpreting it.

We believe that in the area of tax law, like other areas of economic regulation, a plain-meaning determination should not disregard the economic realities underlying the transactions in issue.[14] Here, the summary-judgment evidence shows that all the toys placed in Roark's machines eventually become customers' property, except for those lost, stolen, or damaged. Further, the economic reality of the game is such that customers simply would not part with their money but for the *possibility* of winning a toy. In this practical sense, under *section 151.006(a)(3)*, the transfer of toys is "an integral part" of the amusement service offered by Roark's machines. The Comptroller acknowledged at oral argument that no one would play the game without the possibility **[**12]** of winning a toy. Nothing in *section 151.302(b)* suggests that every single customer must walk away with a toy. That provision requires that "care, custody, and control of the tangible personal property" be "transferred to the purchaser of the service." This transfer in fact occurs and is integral to the success of the game as an amusement service.

The Comptroller's argument that reference to "the purchaser" rather than *a* purchaser requires that the customer must always, inexorably win a toy simply puts too much weight on the commonest article of speech. The wording of the statute and the economic realities of the transaction do not require this "everyone's a winner" result. Indeed the game would lose all intrigue, **[*638]** and thus all profitability, if customers won each and every time. No profit-seeking businessperson would rationally offer such a sure thing. The game would cease to be a game, and thus cease to amuse, and thus cease altogether.

The Comptroller contends that her position is set out in Comptroller *Rule 3.301(b)(2)*,[15] which provides: "The operators of **[**14]** games, or other concessions, in which each participant does not receive some merchandise or prize, become the consumers of merchandise so used by them and are liable to the State of Texas for tax based on the sales price or use of the taxable items purchased for use by them." As explained in her principal brief, the Comptroller's position is that, under *Rule 3.301(b)(2)*, "when each participant does not receive a prize, the game operator—or concessionaire—is not a retailer, but a consumer of the items it purchases to provide

[14] The United States Supreme Court has long observed that statutory determinations in tax disputes should reflect the economic realities of the transactions in issue. *See, e.g.*, *Boulware v. United States, 552 U.S. 421, 429, 128 S. Ct. 1168, 170 L. Ed. 2d 34 (2008)* ("The colorful behavior described in the allegations requires a reminder that tax classifications like 'dividend' and 'return of capital' turn on 'the objective economic realities of a transaction rather than . . . the particular form the parties employed.'") (citation omitted); *Frank Lyon Co. v. United States, 435 U.S. 561, 573, 98 S. Ct. 1291, 55 L. Ed. 2d 550 (1978)* ("In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded 'the simple expedient of drawing up papers' . . . as controlling for tax **[**13]** purposes when the objective economic realities are to the contrary.") (citation omitted); *Comm'r v. Sw. Exploration Co., 350 U.S. 308, 315, 76 S. Ct. 395, 100 L. Ed. 347, 134 Ct. Cl. 903, 1956-1 C.B. 614 (1956)* (noting that "the tax law deals in economic realities, not legal abstractions"). We have similarly recognized, in deciding whether a tax is due, that we should consider the "essence of the transaction" or "the true object of [the] transaction" in issue. *Bullock v. Statistical Tabulating Corp., 549 S.W.2d 166, 167-68 (Tex. 1977)*.

[15] *34 Tex. Admin. Code § 3.301(b)(2)*.

its service; such game operators are therefore not eligible to claim the resale exemption on purchases of toy prizes." Roark disputes that this Rule applies to its machines, describing it as outdated or alternatively invalid, and arguing that other rules apply instead, specifically *Rules 3.301(c)(1)* ("For an explanation of the taxability of an item purchased for use as a prize when the winning of the prizes depends upon chance or skill, see *§ 3.298(f)(1)* of this title (relating to Amusement Services)."), *3.298(f)(1)* ("Sellers of service may issue a resale certificate in lieu of tax to suppliers of tangible personal property only if care, custody, and control of **[**15]** the property is transferred to the client."), and *3.298(f)(2)* ("A service will be considered an integral part of a taxable service if the service purchased is essential to the performance of the taxable service, and without which the taxable service could not be rendered.").[16] The Comptroller disputes the applicability of these Rules to this case. Regardless of which Comptroller Rule applies, the Comptroller cannot through rulemaking impose taxes that are not due under the Tax Code; the question of statutory construction presented in this case ultimately is one left to the courts.

## III. Conclusion

We affirm the court of appeals' judgment and remand the case to the trial court for further proceedings consistent with this opinion.

Don R. Willett

Justice

**OPINION DELIVERED**: March 8, 2013

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[16] *Id. §§ 3.301(c)(1)*, *3.298(f)(1)-(2)*.

# Gulf Chem. & Metallurgical Corp. v. Hegar

Court of Appeals of Texas, Third District, Austin

March 26, 2015, Filed

NO. 03-12-00772-CV

**Reporter**

460 S.W.3d 743; 2015 Tex. App. LEXIS 2825

Gulf Chemical and Metallurgical Corporation, Appellant v. Glenn Hegar, Comptroller of Public Accounts of the State of Texas; and Ken Paxton, Attorney General of the State of Texas, Appellees

**Prior History: [**1]** FROM THE DISTRICT COURT OF TRAVIS COUNTY, 261ST JUDICIAL DISTRICT. NO. D-1-GN-11-003174, HONORABLE STEPHEN YELENOSKY, JUDGE PRESIDING.

**Disposition:** Reversed and Remanded.

## Case Summary

### Overview

HOLDINGS: [1]-Credits provided by a recycling company to its customers, which discounted or completely offset the company's environmental service fees charged in the same transaction pursuant to contracts providing that the credits and fees would be netted and invoiced together, constituted allowances under former 34 Tex. Admin. Code §§ 3.557, 3.549, contemplating a transaction wherein a seller of goods or services allowed the buyer a credit or reduction against an original or stated price; [2]-Because substance rather than form determined whether an adjustment was an allowance, it was immaterial that the company had not characterized the credits as allowances in its federal tax returns; [3]-The company thus was entitled to a refund of franchise taxes by adjusting its computation of gross receipts, as defined in former *Tex. Tax Code Ann. § 171.1121(a)*, to account for the allowances.

### Outcome

Reversed and remanded.

**Counsel:** For Appellee: Mr. Charles K. Eldred, Assistant Attorney General, Financial Litigation, Tax, and Charitable Trusts Division, Austin, TX.

For Appellant: Ms. Olga Goldberg, Mr. Mark W. Eidman, Mr. Doug Sigel, Mr. Matthew K. Ormiston, Ryan Law Firm LLP, Austin, TX.

**Judges:** Before Chief Justice Rose, Justices Puryear and Goodwin.

**Opinion by:** David Puryear

## Opinion

**[*744]** Gulf Chemical and Metallurgical Corporation brought suit under Texas Tax Code Chapters 112 and 171 to recover $1,357,920 in franchise taxes that it paid for tax years 2005, 2006, and 2007. After the parties agreed to an order bifurcating the non-jury trial, the trial court tried the issue of whether the methodology that Gulf sought to use in calculating its franchise tax apportionment factor for the years at issue was proper. The trial court found that Gulf's methodology was not proper and entered a final judgment concluding that Gulf was not entitled to any refund. Gulf appeals. We will reverse the trial court's judgment and remand this cause for further proceedings to determine the amount of refund to which Gulf is entitled.

## BACKGROUND

Gulf performs environmental disposal and recycling services for oil refineries by processing their spent fuel catalyst, recovering the precious metals contained therein, and selling the metals at a profit. According to the deposition **[**2]** of Gulf's controller, Jeffrey Masters, Gulf charges a "service payment" or "environmental fee" to each refinery customer and, as part of the same transaction, provides the customer with a discount in the form of a "metal purchase payment" or "metals credit," which functions as a form of profit-sharing from the metal sales with the customer. Masters explained that even though the two amounts are identified separately on invoices, Gulf considers them as comprising one transaction, and the amounts are "netted" together in determining whether the customer owes Gulf or Gulf owes the customer, depending on the quantity and value of the metals contained in each receipt of spent catalyst.

Masters testified that the "whole purpose" of Gulf's business is to extract and sell the precious metals from the spent catalyst and that without the metal extraction and sale, its "environmental reclamation services" would be "a losing proposition." He referred to Gulf's acquiring the spent catalyst as a "purchase" from the refineries and noted that Gulf's general ledger tracks the service payments and metals credits separately for internal "management reporting purposes" **[*745]** and "tracking costs."[1] Despite these **[**3]** separately tracked "trial balance" accounts, Masters testified that there is a difference between "management reporting" and "financial reporting." Management reporting, he explained, is used for internal purposes, while financial reporting must comply with generally accepted accounting principles (GAAP) and is used for federal and external reporting. Masters testified that under GAAP the service payments and metals credits should be "netted" together to determine Gulf's gross revenue.

Several contracts between Gulf and its customers were submitted as joint exhibits at trial. One contract representative of those in effect for the years at issue specified that Gulf's customer would pay it a "treatment charge of US $[redacted amount] per ton [of spent catalyst] less metal credits based on the 'As Received Weight' of the spent catalyst." Gulf agreed to "apply a credit for content of primary metals contained in the **[**4]** spent catalyst" and that the "metals credit shall be credited [to customer] to offset the treatment charge."[2] The contract further specified that Gulf would submit "one invoice to [customer] by the 15th of every month along with a statement showing . . . quantity of spent catalyst processed, metals credits, processing fee, [and] net fee owing by [customer] or payment to [customer]."

Also admitted as joint exhibits were reports of independent auditors reviewing Gulf's financial statements for each of the three tax years. Under a heading entitled "Revenue Recognition," these reports represented that Gulf "records environmental sales revenue, net of estimated metals credits, when the spent catalyst has been delivered to [Gulf]'s plant" and that "[f]or those sales under specified customer agreements, which have variable contingent pricing components, net revenue, if

[1] The service payments are tracked as "Environmental Income" in account #7000010, while the metals credits are tracked as "Environmental Expenses" in account #7120010. For each tax year at issue, the total of "Environmental Expenses" exceeded the total of "Environmental Income."

[2] This contract was admitted as joint trial exhibit no. 22, entitled "Services Agreement #4600001907," executed by Husky Oil Operations, Ltd. and Gulf on January 1, 2005.

any, related to the variable contingent component is not recognized until such time as the price is fixed and determinable."

Gulf's expert witness, CPA Lester Sprouse, **[**5]** testified that GAAP governs corporations using the accrual method of accounting, which method is appropriate for Gulf's type of business and which method Gulf used during the tax years at issue.[3] He also testified that the "metals credits" Gulf provides to its refinery customers must be considered "allowances" or "sales incentives" under GAAP because they operate as "contra-revenue" to reduce gross receipts. In other words, as a corporation using the accrual method and subject to GAAP, Gulf should net the metals credits with the service payments in determining gross revenue rather than consider the sum total of the service payments as gross revenue.

In reviewing Gulf's federal income tax returns for the three years, Sprouse identified a non-material, "presentation" error in which Gulf erroneously included the metals credits on line 2 of its form 1120[4] **[*746]** as "cost of goods sold" rather than as an "allowance" on line 1, which would have reduced its "gross receipts" entered on line 1.[5] Sprouse averred that not only would it have been "appropriate" for Gulf to have deducted **[**6]** the metals credits before determining gross revenue, but because Gulf was using the accrual method and following GAAP, the metals credits "should have been netted in [Gulf's] gross receipts" on line 1. However, Sprouse testified that the way a corporation "presents" its gross receipts on form 1120, even if erroneous, does not "change" the accounting method it uses in its business or affect GAAP's treatment of allowances. With respect to this particular error, Sprouse noted that there was no need or incentive for Gulf to amend its federal tax returns because there would have been no difference in its ultimate tax liability (because the metals credits were deducted elsewhere from taxable income) and, therefore, "no reason" to amend; amendment would merely constitute an added expense.

The trial court also admitted as a joint exhibit an abstract issued by the Emerging Issues Task Force (EITF) which, according to Sprouse, is a subcommittee of the American Institute **[**7]** of Certified Public Accountants and Financial Accounting Standards Board. Sprouse explained that this abstract, known as EITF 01-09, became effective in 2002. *See* Emerging Issues Task Force Issue No. 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)* (abstract), ¶9. EITF 01-09 specifies that its purpose is to "codify and reconcile [certain issues addressing] the accounting for consideration given by a vendor to a customer." It further states that "cash consideration (including a sales incentive) given by a vendor to a customer is presumed to be a reduction of the selling prices of the vendor's products or services and, therefore, should be characterized as a reduction of revenue when recognized in the vendor's income statement." Sprouse explained that as soon as EITF abstracts are issued, "they become GAAP," and that EITF 01-09 specifically applies to the metals credits here, which operate as sales incentives, requiring them to be netted against gross receipts. The Comptroller did not rebut Sprouse's or Masters's testimony.

The main issue at the bench trial was whether, for Texas franchise tax purposes, Gulf should be **[**8]** permitted to report as "gross receipts"

[3] On its federal income tax returns for the three years at issue, Gulf "checked the box" for the accrual method of accounting.

[4] Form 1120 is the standard federal income tax return form for corporations.

[5] Line 1 on form 1120 requires the entry of (a) "Gross receipts or sales," (b) "Less returns and allowances," (which space Gulf left blank) for a total (c) "Bal[ance]."

the amount of each service payment, netted with each corresponding metals credit, or whether it must report the full total of service payments, without adjustment for the metals credits. This is a significant distinction, as the amount of franchise tax that Gulf owes is directly affected by the "apportionment factor," which at all relevant times was computed using a corporation's "gross receipts."[6] Act of May 7, 1999, 76th Leg., R.S., ch. 184, § 2, *sec. 171.106(a)*, 1999 Tex. Gen. Laws 651, 652 (amended 2006) (current version at *Tex. Tax Code § 171.106*) (providing formula to apportion taxable capital and taxable earned surplus to this state, where gross receipts are component) (hereinafter Former *Tex. Tax Code § 171.106*); Act of May 25, 1993, 73d Leg., R.S., ch. 546, § 8, *sec. 171.1121(a)*, **[*747]** 1993 Tex. Gen. Laws 2043, 2044 (amended 2006) (current version at *Tex. Tax Code § 171.1121*) (providing definition of gross receipts for taxable earned surplus) (hereinafter Former *Tex. Tax Code § 171.1121*).[7]

This dispute initially arose when the Comptroller audited Gulf for tax years 1997-2000, a period for which the Comptroller did not permit Gulf to report its gross receipts on a netted basis and which determination Gulf challenged in two lawsuits, which were settled by an agreed judgment. Gulf argues that since EITF became effective in 2002, the metals credits are now indisputably "allowances" that operate to reduce gross receipts. However, knowing the Comptroller's position on the netting of the service payment and metals credit from its prior audit and seeking to avoid incurring a penalty and interest, Gulf calculated and paid its franchise taxes without netting **[**10]** the amounts but concurrently filed a refund claim to recover the amount it claims it overpaid. After the bench trial, the trial court agreed with the Comptroller and concluded that Gulf is not entitled to net the amounts and, therefore, is not entitled to any refund.

## STANDARD OF REVIEW

While Gulf makes several arguments supporting its contention that the trial court erred in making its determination that Gulf is not entitled to a refund, its issues on appeal stem from the trial court's construction of relevant Tax Code provisions and Comptroller rules, which are legal questions we review de novo. *See* *7-Eleven, Inc. v. Combs, 311 S.W.3d 676, 683 (Tex. App.—Austin 2010, pet. denied)*. When resolving an issue of statutory construction, we must first and foremost follow the plain language of the statute. *General Motors Corp. v. Bray, 243 S.W.3d 678, 685 (Tex. App.—Austin 2007, no pet.)*. Under the plain meaning rule, if a statute is clear and unambiguous, it should be given its commonly understood meaning without resort to extrinsic aids of statutory construction. *Id*. Where a word appearing in a statute or rule is undefined by the legislature or governing agency, the word is given its plain and common meaning. *See* *McIntyre v. Ramirez, 109 S.W.3d 741, 745 (Tex. 2003)*. Only if the statutory language is ambiguous do we defer to an agency's construction. *See* *Fiess v. State Farm Lloyds, 202 S.W.3d 744, 747 (Tex. 2006)*.

Administrative rules are ordinarily construed **[**11]** in the same manner as

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[6] The franchise-tax statutes and the Comptroller's rules governing Gulf's liability for the tax years at issue in this case have been amended or repealed since Gulf filed its tax returns. Therefore, we cite to the versions in effect during the relevant years.

[7] Former ***section 171.106(a)*** provided that a corporation's **[**9]** taxable earned surplus and taxable capital "are apportioned to this state to determine the amount of tax imposed under *Section 171.002(b)(1)* [providing franchise tax rates ] by multiplying the taxable earned surplus [or taxable capital] by a fraction, the numerator of which is the corporation's gross receipts from business done in this state . . . and the denominator of which is the corporation's gross receipts from its entire business." Act of May 7, 1999, 76th Leg., R.S., ch. 184, § 2, ***sec. 171.106(a)***, 1999 Tex. Gen. Laws 651, 652 (amended 2006) (current version at ***Tex. Tax Code § 171.106***).

statutes. *Rodriguez v. Service Lloyds Ins. Co., 997 S.W.2d 248, 254 (Tex. 1999)*; *7-Eleven, 311 S.W.3d at 683*. Unless a rule is ambiguous, we follow the rule's clear language; when there is vagueness, ambiguity, or room for policy determinations in a rule, we defer to the agency's interpretation unless it is plainly inconsistent with the language of the rule. *BFI Waste Sys. of N. Am., Inc. v. Martinez Envtl. Grp., 93 S.W.3d 570, 575 (Tex. App.—Austin 2002, pet. denied)*.

We review a trial court's conclusions of law de novo, *Botter v. American Dental Ass'n, 124 S.W.3d 856, 860 (Tex. App.—Austin 2003, no pet.)*, and do not defer to the trial court on questions of law, *Perry **[*748]** Homes v. Cull, 258 S.W.3d 580, 598 (Tex. 2008)*. For mixed questions of law and fact, we defer to the trial court's factual determinations if supported by the evidence but review its legal determinations de novo. *Brainard v. State, 12 S.W.3d 6, 30 (Tex. 1999)*.

## DISCUSSION

This dispute pits form against substance. Gulf argues, essentially, that the substance of these transactions governs, and that we must characterize the metals credits as GAAP does. In determining the Texas apportionment factor, Gulf asserts, the rules of the accrual method of accounting should take precedence over a non-binding, non-material "presentation error" on its federal tax returns. The Comptroller rejoins that Gulf is bound by the way it characterized the metals credits on its federal tax returns and may not attempt to "retroactively change" its accounting method merely to reduce its franchise tax liability. **[**12]** We disagree with the Comptroller that Gulf is attempting to "change" its accounting method or that, in this case, Gulf is bound by its characterization of the metals credits on its federal tax returns. We agree with Gulf that the characterization of the metals credits turns on the substance of the transactions and that, based on this record, the metals credits must properly be considered "allowances" under Texas tax law and should operate to reduce gross receipts.

During the years at issue, *section 171.1121 of the Tax Code* defined "gross receipts" as "all revenues reportable by a corporation on its federal tax return, without deduction for the cost of property sold, materials used, labor performed, or other costs incurred, unless otherwise specifically provided in this chapter." Former *Tex. Tax Code § 171.1121(a)*. Former *section 171.1121* further provided that "a corporation shall use the same accounting methods to apportion taxable earned surplus as used in computing reportable federal taxable income." *Id*.

The Comptroller's Rule 3.557 in effect for the applicable period similarly provided that "gross receipts" means "all revenues that are recognized under the methods used for federal income tax purposes for the tax reporting period without deduction for the cost of property **[**13]** sold, materials used, labor performed, or other costs incurred, *unless otherwise specifically provided for in this section* or Tax Code, Chapter 171." 28 Tex. Reg. 1218 (2003), *repealed by* 38 Tex. Reg. 5109 (2013) (former 34 Tex. Admin. Code § 3.557) (Comptroller of Pub. Accounts, Earned Surplus: Apportionment) (hereinafter Former Rule 3.557) (emphasis added). Former Rule 3.557(e) further specifically provided that "sales returns and allowances that a seller allows reduce gross sales of the seller in the computation of gross receipts." *Id*.(e)(31).[8]

[8] Similarly, the applicable Comptroller Rule applying to the determination of gross receipts for the apportionment of taxable capital specifically excluded "allowances" from gross receipts. *See* 25 Tex. Reg. 12627 (2000), *adopted* 26 Tex. Reg. 1873 (2001), *repealed by* 38 Tex. Reg. 5109 (2013) (former 34 Tex. Admin. Code § 3.549(e)(35)). The amount of franchise tax due was determined during the applicable years by a calculation necessitating two components: "net taxable capital" and "net taxable **[**14]** earned

Therefore, we are left to determine **[*749]** whether the "metals credits" at issue qualify as "allowances" as contemplated by the applicable regulations, which is a legal determination we review de novo.[9] *See* *Botter, 124 S.W.3d at 860*. If so, Gulf is entitled to a refund.

Courts **[**15]** have not had occasion to construe Former Rule 3.557's use of the term "allowance," and neither the Tax Code nor the Comptroller's regulations provide a definition for the term. Therefore, we consider its ordinary, common meaning. *See* *McIntyre, 109 S.W.3d at 745*. Allowance is defined as a "deduction," Black's Law Dictionary 89 (9th ed. 2009), and "a reduction from a list price or stated price (as one granted on used products turned in or because of previous credit)," Webster's Third New Int'l Dictionary 58 (2002). These definitions and the use of the term "allowance" in Former Rule 3.557 imply a transaction between two parties wherein the seller (of goods or services) "allows" the buyer a credit or reduction against an original or stated price.

The uncontroverted evidence in the form of (1) the contracts between Gulf and its customers, (2) the professional auditors' reports of how and when Gulf records revenue in its financial statements, and (3) the testimony of Masters and Sprouse leads us to conclude that the metals credits must be defined as allowances, contrary to the trial court's findings that there was "no evidence" that the metals credits constitute allowances. Specifically, the governing contracts provided that the two **[**16]** fees would be netted and invoiced together and contemplated instances when Gulf would actually receive *no* payment (i.e., no receipt or revenue) from its customer but would, rather, pay the customer for the value of the metals contained in the spent catalyst. Once Gulf received the spent catalyst from its customer, under the applicable contracts and as Masters explained Gulf's operations, Gulf was entirely responsible for processing the catalyst, extracting the metals, computing the amount of metals credit, and invoicing the customer for the difference between the service payment and metals credit, if any. With respect to the invoiced transactions wherein the metals credit exceeded the contracted service payment, Gulf would recognize *no* revenue and receive *no* payment from its customer. When the contracted service payment exceeded the metals credit, Gulf would recognize revenue, but only in the amount of the difference between the two amounts. Under these circumstances, the metals credits must be considered allowances as a matter of law. Accordingly, Gulf must be permitted to exclude from its computation of gross receipts any transactions in which its issuance of a "metals credit" exceeded **[**17]** its receipt of a "service payment" and, for transactions in which the service payment exceeded the metals credit, net together the service payment and metals credit to determine gross receipts.

Additionally, we consider persuasive case law from the Tax Court of the United States that directs courts to look to the substance of a transaction rather than its **[*750]** form when determining whether an adjustment should

surplus." *See* Act of Aug. 12, 1991, 72d Leg., 1st C.S., ch. 5, § 8.031, *sec. 171.002*, 1991 Tex. Gen. Laws 134, 154 (amended 2006) (current version at *Tex. Tax Code § 171.002*) (providing rates and formula for computation of franchise tax due). Because the parties' briefs focus on whether the metals credits reduce gross receipts for purposes of earned surplus, our discussion will reference the applicable statutes and rules addressing earned surplus. However, our analysis and holding will equally apply to the issue of whether the metals credits reduce gross receipts for the taxable-capital component of the franchise-tax calculation.

[9] The trial court made findings of fact and conclusions of law, several of which Gulf challenges on appeal in addition to its first issue contending that the trial court erred in determining that it is not entitled to a refund based on netting the two trial balance accounts. The trial court's findings of fact nos. 9 and 10 found that Gulf offered "no evidence" that the metals credits "constituted an allowance" or "should be treated as an allowance." Its corresponding conclusion of law determined that the metals credits do not "qualify" as allowances under the Comptroller's applicable rules.

properly be considered an allowance. In *Pittsburgh Milk*, the Tax Court considered whether a corporation's sales of milk at illegally discounted prices should be used to compute gross sales or whether the fictitious higher prices entered in the corporation's books should be used. Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707, 708 (1956). The Tax Court held that, notwithstanding the illegal nature of the sales, the gross sales must be computed using the agreed net prices rather than the fictitious higher prices. *Id*. It reasoned that "each type of transaction must be analyzed with respect to its own facts and surrounding circumstances," and that the "actual facts, not bookkeeping entries, control the determination of taxable income." Id. at 717. The "test" to be applied is, "What did the parties really intend, and for what purpose or consideration **[**18]** was the allowance actually made? Where, as here, the intention and purpose of the allowance was to provide a formula for adjusting a specified gross price to an agreed net price, and where the making of such adjustment was not contingent on any subsequent performance or consideration from the purchaser, then, regardless of the time or manner of the adjustment, the net selling price agreed upon must be given recognition for income tax purposes." *Id*.; *see also* State v. Shell Oil Co., 747 S.W.2d 54, 56 (Tex. App.—Austin 1988, no writ) (franchise tax statute contemplates that tax be determined upon corporation's "true financial condition" and holding that corporation was entitled to exclude from its calculation of taxable capital its "contra-asset" accounts, consisting of amortized unproductive leaseholds, because such accounts were not available for use by company and including them would "project a distorted view of the taxpayer's financial condition"). We believe that this reasoning is sound, applies to the facts in this case, and requires a determination that the metals credits were allowances.[10] Furthermore, this reasoning aligns with contemporary GAAP principles on the treatment of sales incentives and other consideration given by a vendor to a customer **[**19]** as explained in EITF 01-09.

## CONCLUSION

We hold that the "metals credits" at issue in this case constitute "allowances" **[*751]** under Former Comptroller Rules 3.557 and 3.549 and that, therefore, Gulf was entitled to a refund of franchise taxes by adjusting its computation of gross receipts to account for these allowances. The trial court erred in determining otherwise, and we reverse its final judgment and remand this cause for further proceedings, in accordance with this opinion, to determine the amount of refund to which Gulf is entitled.

David Puryear, Justice

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[10] Contrary to the spirit of *Pittsburgh Milk*, the evidence that the Comptroller cites elevates form over substance: (1) the federal tax returns that Gulf filed for each of the three years in which it failed to characterize the metals credits as allowances and (2) the "trial balance sheets" in which Gulf internally "tracked" the metals credits (as "environmental expenses") separately from the service payments (as "environmental income"). However, the legal determination of whether the metals credits constitute allowances under Texas law cannot turn on the labeling of such credits in Gulf's internal books or tax forms but must turn, rather, on the substance of the transactions. Additionally, the Comptroller does not cite any authority rendering Gulf's characterization of the metals credits on its federal tax returns as binding on its determination of gross receipts for the franchise tax. Although the Comptroller contends that by attempting to reduce its gross receipts by these "allowances" Gulf is unlawfully and retroactively "changing its accounting method" from the method it used in "computing reportable federal taxable income," we do not consider Gulf's non-material **[**20]** error on its federal return as reflective of a "different accounting method" from the accrual method its witnesses testified it has used at all relevant times. However, even if Gulf could be considered to be "changing" its accounting method by seeking to exclude from its gross receipts the metals credits, the Tax Code explicitly permitted a corporation to change its accounting method "used to calculate gross receipts" once every four years, *without* consent of the Comptroller. *See* Act of May 25, 1993, 73d Leg., R.S., ch. 546, § 8, sec. 171.1121(a), 1993 Tex. Gen. Laws 2043, 2044 (amended 2006) (current version at Tex. Tax Code § 171.1121).

Before Chief Justice Rose, Justices Puryear and Goodwin

Reversed and Remanded

Filed: March **[**21]** 26, 2015

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# *Shepard's®:* Gulf Chem. & Metallurgical Corp. v. Hegar, 460 S.W.3d 743

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# [Hallmark Mktg. Co., LLC v. Hegar]

Supreme Court of Texas

December 9, 2015, Argued; April 15, 2016, Opinion Delivered

NO. 14-1075

**Reporter**
488 S.W.3d 795; 2016 Tex. LEXIS 314; 59 Tex. Sup. J. 657; 2016 WL 1516774

HALLMARK MARKETING COMPANY, LLC, PETITIONER, v. , COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS, AND KEN PAXTON, ATTORNEY GENERAL OF THE STATE OF TEXAS, RESPONDENTS

**Prior History: [**1]** ON PETITION FOR REVIEW FROM THE COURT OF APPEALS FOR THE THIRTEENTH DISTRICT OF TEXAS.
*[Hallmark Mktg. Co., LLC v. Combs, 2014 Tex. App. LEXIS 12339 (Tex. App. Corpus Christi, Nov. 13, 2014)]*

## Case Summary

### Overview

HOLDINGS: [1]-Because *[Tex. Tax Code Ann. § 171.105(b)]* provided that only the net gain from the sale of investments should be included in the apportionment-factor denominator, and *[34 Tex. Admin. Code § 3.591]* was not entitled to deference because it directly conflicted with the statute, a taxpayer was not required to include a net loss from the sale of investments and capital assets in its apportionment-factor denominator.

### Outcome

Reversed and remanded.

**Counsel:** For Hallmark Marketing Company, LLC, Petitioner: Mark W. Eidman, Quentin Doug Sigel, Ryan Law Firm, LLP, Austin, TX; Olga Goldberg, Sutherland Asbill & Brennan LLP, Houston, TX.

For Glenn Hegar, Comptroller of Public Accounts of the State of Texas, Ken Paxton, Attorney General of the State of Texas, Respondens: Charles E. Roy, First Assistant Attorney General, Office of the Attorney General, Austin, TX; Charles Kenneth Eldred, Financial & Tax, Litigation Division, Office of the Attorney General, Austin, TX; James Edward Davis, Rance L. Craft, Shannon Michelle Ryman, Office of the Attorney General, Austin, TX; Robert B. O'Keefe, General Litigation Division, Austin, TX; Warren Kenneth Paxton, Attorney General of Texas, Office of the Attorney General, Austin, TX.

**Judges:** Jeffrey V. Brown, Justice.

**Opinion by:** Jeffrey V. Brown

## Opinion

**[*796]** JUSTICE BROWN delivered the opinion of the Court.

This case arises from a franchise-tax protest suit Hallmark filed against the state comptroller. The Tax Code provides that "only the net gain" from the sale of investments should be included in a key component of the statutory franchise-tax formula. The **[**2]** comptroller, however, adopted a rule requiring businesses to include net gain *or* a net loss. As a result, Hallmark paid more than $200,000 in taxes than it believes was required, so it sued the comptroller for a refund. The trial court and court of appeals deferred to the comptroller's rule. Because we agree with Hallmark that "only the net gain" necessarily excludes a net loss, we reverse.

**I**

Texas imposes a franchise tax on businesses based or operating in our state. *See Tex. Tax Code § 171.001*. In its simplest form, franchise-tax liability is calculated by multiplying a business's taxable margin by the applicable franchise-tax rate. *See id. § 171.002*. Taxable margin is determined by multiplying a business's total margin by an apportionment factor designed to limit the franchise tax to revenue attributable to business conducted in Texas. *See id. § 171.101*. The apportionment-factor numerator consists of receipts from business conducted in Texas and the denominator consists of receipts from all business anywhere, including Texas. *See id. § 171.106(a)*.

Under this formula, franchise-tax liability increases as the ratio of Texas receipts to total receipts increases. If the numerator (Texas receipts) increases but the denominator (all receipts) **[**3]** stays the same, receipts from Texas business make up a larger share of total receipts and franchise-tax liability increases. If, on the other hand, the numerator decreases against **[*797]** the same denominator, receipts from Texas business make up a lesser share of total receipts, and franchise-tax liability decreases.

In implementing Texas' statutory franchise-tax liability scheme, the comptroller adopted a rule providing that "[i]f the combination of net gains and losses results in a net loss, the taxable entity should net the loss against other receipts, but not below zero." *34 Tex. Admin. Code § 3.591(e)(2)*. Accordingly, after auditing Hallmark's 2008 franchise-tax report, the comptroller concluded Hallmark miscalculated its apportionment factor by failing to include a net loss of more than $628 million from the sale of investments. This loss, when included in the apportionment-factor denominator, would have lowered the denominator, resulting in a higher ratio of Texas receipts to total receipts and therefore a higher tax bill for Hallmark.

In response, Hallmark argues that the comptroller's rule conflicts with the very statute it purports to enforce. *Tax Code section 171.105(b)* provides that "[i]f a taxable entity sells an investment or capital asset, the **[**4]** taxable entity's gross receipts from its entire business for taxable margin includes *only the net gain* from the sale." *Tex. Tax Code § 171.105(b)* (emphasis added). Because Hallmark incurred a net loss, not a net gain, it argues it adhered to the Tax Code by not including the net loss in its apportionment-factor denominator.

The trial court agreed with the comptroller that Hallmark should have included the net loss, and accordingly granted the comptroller's motion for partial summary judgment and denied Hallmark's. The court of appeals affirmed, concluding the comptroller's rule was entitled to deference because "net gain" in *Tax Code section 171.105(b)* is ambiguous. *No. 13-14-00093-CV, 2014 Tex. App. LEXIS 12339, 2014 WL 6090574, *4-5 (Tex. App.—Corpus Christi Nov. 13, 2014)* (mem. op). It supposed that "'net gain' may refer to the particular gain or loss that results from each individual sale when proceeds are offset by costs" or "may instead refer to the taxpayer's cumulative gain or loss on its various investment and capital asset sales made throughout the year." *2014 Tex. App. LEXIS 12339, [WL] at *4*.

We conclude that even if "net gain" is ambiguous as the court of appeals suggests, the ambiguity is irrelevant to this case. Here, neither party disputes that Hallmark suffered only a net *loss*. The statute requires inclusion of "only the net gain," and under no reading can "net gain" **[**5]** include a net loss. Accordingly, we cannot defer to the comptroller's rule requiring inclusion of a net loss in Hallmark's apportionment-factor denominator because it conflicts with the plain language of *Tax Code section 171.105(b)*.

## II

The comptroller is charged with administering the franchise tax and has broad discretion to adopt rules for its collection as long as those rules do not conflict with state or federal law. *See* *Tex. Gov't Code § 403.011* (enumerating general powers of comptroller's office); *Tex. Tax Code § 111.002(a)* (granting comptroller rulemaking power). "If there is vagueness, ambiguity, or room for policy determinations" in the language of a statute, "we normally defer to [an] agency's interpretation unless it is plainly erroneous or inconsistent with the language of the statute." *TGS-NOPEC Geophysical Co. v. Combs, 340 S.W.3d 432, 438 (Tex. 2011)*.

*Section 171.105(b)*'s interpretation is a matter of statutory construction that we review de novo. *See* *Greater Houston P'ship v. Paxton, 468 S.W.3d 51, 58 (Tex. 2015)*. Our goal in interpreting any statute is to ascertain and give effect **[*798]** to the legislature's intent as expressed by the language of the statute. *See* *City of Lorena v. BMTP Holdings, L.P., 409 S.W.3d 634, 641 (Tex. 2013)*. We presume the legislature chose a statute's language with care, including each word chosen for a purpose while purposely omitting words not chosen. *See* *In re M.N., 262 S.W.3d 799, 802 (Tex. 2008)*. If a statute is unambiguous, we adopt the interpretation supported by its plain **[**6]** language unless such an interpretation would lead to absurd results. *See* *Tex. Dep't of Protective & Regulatory Servs. v. Mega Child Care, Inc., 145 S.W.3d 170, 177 (Tex 2004)*.

## III

### A

The parties agree on a great deal in this case. They agree Hallmark incurred a net loss, not a net gain, on its sale of investments. They further agree on the amount of that net loss—exactly $628,243,514. They even generally agree on the issue that befuddled the court of appeals: how to calculate "net gain." Specifically, they agree that the Austin court of appeals answered that question over 40 years ago in *Calvert v. Electro-Science Inv'rs, Inc., 509 S.W.2d 700 (Tex. Civ. App.—Austin 1974, no writ)*.

The *Electro-Science* court encountered the same dilemma as the court of appeals in this case when interpreting the predecessor statute to current *Tax Code section 171.105(b)*. *See* *id. at 701* (interpreting *Tex. Rev. Civ. Stat. art. 12.02(1)(d)*) ("Provided, however, that, as to the sale of investments and capital assets, the term 'total gross receipts of the corporation from its entire business' shall include only the Net gain from such sales."). The taxpayer argued that in calculating net gain, "there are assumed to be a series of sales or transactions whereby either a gain or a loss can occur, so that by evaluating or comparing the results of such sales or transactions, a 'net gain' can be determined." *Id.* The court agreed, concluding that "net gain requires that gains and losses **[**7]** be offset against one another in order that a net figure be obtained." *Id. at 702*.

No one evidently has ever said otherwise. Indeed, soon after *Electro-Science* was issued, the comptroller adopted a conforming approach of offsetting cumulative gains and losses to determine net gain. *See* Tex. Comp. of Pub. Accts., Rule 026.02.12.013(2)(k) (1975) ("Net gains and losses rather than gross sales price from the sales of investments and capital assets shall be added together to determine the total receipts from such transactions."). That understanding is built into the current rule in dispute in this case, which provides that "net gains and losses from sales of investments and capital assets must be added to determine the total gross receipts from such transactions." *34 Tex. Admin. Code § 3.591*.

Acknowledging that *Electro-Science* governs how net gain is calculated, the comptroller insists he faithfully enforces that precedent by requiring inclusion of a net loss in the apportionment-factor denominator because *Electro-Science* calls for offsetting losses against gains when calculating net gain. But *Electro-Science* simply does not go as far as the comptroller would like. True, losses are always taken into account when net gain is **[**8]** calculated. But that does not answer the question in this case. At issue here is what happens when those losses overtake the gains and produce a net loss rather than a net gain. *Electro-Science* clarified how to calculate net gain, but it did not speak to the statutory treatment of a net loss.

We, of course, are not bound by *Electro-Science* or the comptroller rules that have followed its lead. But it appears this approach **[*799]** has proved serviceable for more than 40 years, and we are therefore loath to disturb it. But more importantly, we do not need to relitigate the question in order to determine Hallmark did not have a net gain under any calculation. Everyone agrees Hallmark incurred a net loss. Even if arguments can be made that various calculations might result in a different net-gain figure, the parties here agree on the calculation to be used and agree it results in a net loss. If there is any ambiguity to be found in "net gain," it is a red herring in the resolution of *this* case.

**B**

Likely because statutory ambiguity is the quickest path to administrative deference, the comptroller argues the court of appeals correctly found "net gain" ambiguous even as he acknowledges *Electro-Science* ***[**9]*** answers the question. But the ambiguity the comptroller suggests is not the one found by the court of appeals, which questioned whether "net gain" should be calculated on a per-transaction or cumulative basis. The comptroller instead asks if net gain "always assume[s] a gain even after the cost(s) have been offset or does the term mean gain or loss after the cost(s) have been considered?" In other words, can net gain sometimes mean net loss if losses outstrip gains? This is another issue altogether, and the answer is obvious and easy: No. However net gain is calculated, a statutory net gain cannot simultaneously be a net loss. *See, e.g.*, BLACK'S LAW DICTIONARY 1088 (10th ed. 2014) (defining "net loss" as "[t]he excess of all expenses and losses over all revenues and gains). Accountants might dispute how to properly offset losses against gains and whether the correct calculation should result in a positive or negative figure, but none can dispute that if that end result is a positive number, it's a net gain, and if it's a negative number, it's a net loss.

Again, this case does not concern whether Hallmark's calculation should have resulted in a positive or negative number. *Cf. Bullock v. King Res. Co., 555 S.W.2d 789, 791 (Tex. Civ. App.—Waco 1977, no writ)* (comptroller unsuccessfully **[**10]** argued taxpayer's accounting, which showed a net loss, should have resulted in a net gain). The parties agree Hallmark incurred a net loss; the comptroller just suggests that "net gain" can be read expansively enough to *include* a net loss. Simply put, the comptroller's reading would rewrite the statute to say Hallmark should include "only the net gain *or net loss*." Not only would this add to the statute's plain language, it would effectively write the word "only" out of the statute. "Only" is defined as "alone in a class or category." MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 867 (11th ed. 2012). Here, it plainly serves to limit consideration of any figure that is not a net gain. But if net losses are also fair game, what else is there to exclude?

Moreover, it appears that following *Electro-Science* the comptroller conceded a net loss would not be included under the substantively identical predecessor statute to *section 171.105(b)*. In the same rule the comptroller adopted codifying the *Electro-Science* court's approach to calculating net gain, it further decreed that as to the apportionment-factor denominator, "[i]f there is a net loss, the corporation must report zero receipts from these transactions." *See* **[**11]** Tex. Comp. of Pub. Accts., Rule 026.02.12.013(2)(k) (1975). This interpretation appears to have stood until 2009, though the comptroller acknowledges current *section 171.105(b)* is "substantively the same statute" as the predecessor considered in *Electro-Science*. *Compare* 34 TEX. ADMIN. CODE § 3.549(e)(3)(A) (2006) ("If the combination of net gains and losses **[*800]** results in a net loss, the corporation must report zero gross receipts from such transactions.") with *id.* *§ 3.591(e)(2) (2009)* ("If the combination of net gains and losses results in a net loss, the taxable entity should net the loss against other receipts, but not below zero."). Considering the history of our franchise-tax scheme and the comptroller's interpretation of it, his position in this case can be fairly considered novel.

### C

Perhaps anticipating that arguing "only the net gain" should include "net loss" might prove unavailing, the comptroller directs us to statutes other than *section 171.105(b)* to support his position. One provides: "In apportioning margin, receipts excluded from total revenue by a taxable entity under *Section 171.1011* may not be included in . . . the receipts of the taxable entity from its entire business done as determined under *Section 171.105*." *Tex. Tax Code § 171.1055(a)*. The comptroller contends that because Hallmark accounted for its $628 million loss as "an amount reportable as income" for its 2008 federal taxes, *section 171.1055(a)* prohibits Hallmark from not also accounting for the net loss when calculating its apportionment-factor denominator under *section 171.105(b)*. This argument is predicated **[**12]** on Hallmark's reporting of its "amount reportable as income [on] Internal Revenue Service Form 1120" under *Tax Code section 171.1011(c)(1)(A)(ii)*. In the same vein, the comptroller urges that *section 171.1121(b)* requires a business to "use the same accounting methods to apportion margin as used in computing margin."

*Section 171.105(b)* addresses a specific issue—what to do with the proceeds from the sale of an investment when calculating the apportionment-factor denominator—and lays out a clear rule: include "only the net gain from the sale." If we perceived a conflict among these provisions we would be forced to conclude the more specific *section 171.105(b)* controls over the more general provisions relied on by the comptroller. *See* *Tex. Lottery Comm'n v. First State Bank of DeQueen, 325 S.W.3d 628, 639 (Tex. 2010)* ("[W]e construe statutes by first looking to the statutory language for the Legislature's intent, and only if we cannot discern legislative intent in the language of the statute itself do we resort to canons of construction or other aids such as which statute is more specific."). But we need not go that far because neither provision contradicts *section 171.105(b)*'s directive to include only a net gain.

Because Hallmark included its net loss under *section 171.1011*, the comptroller argues, it must do the same for *section 171.105*. But that is not what *section 171.1055(a)* requires. It provides that receipts "*excluded* from **[**13]** total revenue" under *section 171.1011* "may not be *included*" in *section 171.105*. And Hallmark did just the opposite—it *included* its net loss under *section 171.1011* and *excluded* it from *section 171.105*. In doing so, Hallmark honored the reporting requirement in *section 171.1011(c)(1)(A)(ii)* and the plain language in *section 171.105(b)* by excluding its net loss when calculating its apportionment-factor denominator.

Nor is *section 171.1121(b)* helpful. The comptroller urges that it requires businesses to use "the same accounting methods to apportion margin as used in computing margin," but he fails to cite the immediately preceding qualifier: "[e]xcept as otherwise provided by [chapter 171]." To the extent the failure to include a net loss when calculating the apportionment-factor denominator is a departure from one or more "accounting methods," it is a departure blessed by the Tax Code.

**[*801] D**

Having concluded the court of appeals' perceived ambiguity has no bearing on this case and that *section 171.105(a)* means just what it says—"only the net gain from the sale" of investments should be included in the apportionment-factor denominator—we turn to the comptroller's rule to the contrary. We generally defer to an agency's "reasonable interpretation of a statute, but a precondition to agency deference is ambiguity; 'an agency's opinion cannot change **[**14]** plain language.'" *Combs v. Health Care Servs. Corp., 401 S.W.3d 623, 630 (Tex. 2013)* (quoting *Fiess v. State Farm Lloyds, 202 S.W.3d 744, 747 (Tex. 2006))*. The comptroller's rule provides that "[i]f the combination of net gains and losses results in a net loss, the taxable entity should net the loss against other receipts, but not below zero." *34 Tex. Admin. Code § 3.591*. It is not entitled to our deference because it directly conflicts with *Tax Code section 171.105(b)*, which provides that "only the net gain from the sale" of investments should be included in the apportionment-factor denominator.

* * *

We hold that *Tax Code section 171.105(b)* does not require Hallmark to include a net loss from the sale of investments and capital assets in its apportionment-factor denominator. Accordingly, we reverse the court of appeals' judgment and remand the case to the trial court for further proceedings consistent with this opinion.

Jeffrey V. Brown

Justice

OPINION DELIVERED: April 15, 2016

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# Hegar v. CGG Veritas Servs. (U.S.), Inc.

Court of Appeals of Texas, Third District, Austin

March 9, 2016, Filed

NO. 03-14-00713-CV

**Reporter**

2016 Tex. App. LEXIS 2439

Glenn Hegar, Comptroller of Public Accounts of the State of Texas, and Ken Paxton, Attorney General of the State of Texas, Appellants v. CGG Veritas Services (U.S.), Inc., Appellee

**Prior History: [*1]** FROM THE DISTRICT COURT OF TRAVIS COUNTY, 353RD JUDICIAL DISTRICT. NO. D-1-GN-12-001316, HONORABLE TIM SULAK, JUDGE PRESIDING.

**Disposition:** Affirmed.

## Case Summary

### Overview

HOLDINGS: [1]-In a taxpayer's action to recover a refund after the State disallowed its calculation of its margin by subtracting from its total revenue an amount for cost of goods sold (COGS), as determined under *Tex. Tax Code Ann. § 171.1012*, the trial court's findings that the taxpayer's seismic services and products were an integral, essential, and direct component of the drilling process was amply supported by record evidence; [2]-Because oil and gas wells were real property, the taxpayer's services therefore constituted "labor furnished to a project for the construction of real property" as required under *§ 171.1012(i)*; [3]-The seismic data produced by the taxpayer provided a roadmap or blueprint for the project, which its customers used as a guide for where to drill wells and how deep to drill wells.

### Outcome

Judgment affirmed.

**Counsel:** For Appellant: Mr. Joseph D. Hughes, Assistant Solicitor General, General Litigation, Austin, TX; Ms. Autumn Hamit Patterson, Office of the Attorney General, Austin, TX; Mr. Charles, K. Eldred, Assistant Attorney General, Financial Litigation, Tax and Charitable Trusts Division, Austin, TX.

For Appellee: Ms. Danielle V. Ahlrich, Ms. Amanda G. Taylor, Ms. Lacy L. Leonard, Martens, Todd, Leonard, Taylor & Ahlrich, Austin, TX.

**Judges:** Before Chief Justice Rose, Justices Pemberton and Field.

**Opinion by:** Scott K. Field

## Opinion

### MEMORANDUM OPINION

CGG Veritas Services (U.S.), Inc. (CGG) sued Glenn Hegar, Comptroller of Public Accounts of the State of Texas, and Ken Paxton, Attorney General of the State of Texas (collectively, the State), seeking a refund of franchise taxes that CGG paid under protest.[1] *See Tex. Gov't Code*

[1] This appeal was originally filed in the names of Susan Combs, predecessor to the present Comptroller of Public Accounts of the

§§ 403.201-.221 (governing protest suit after payment under protest); Tex. Tax Code §§ 112.001-.156 (governing taxpayer suits). CGG asserted that the State erroneously disallowed its "cost of goods sold" (COGS) deduction for the 2008 tax year.[2] The State filed a counterclaim asserting that CGG overstated its Research and Development Credit (R&D Credit) for the relevant tax year, resulting in an underpayment of taxes. After a bench trial, the trial court concluded that CGG was entitled to the COGS deduction. The parties stipulated to an agreed amount for the R&D Credit, and the trial court rendered judgment that CGG's tax due for the 2008 tax year was $1,721,022.23. On appeal, the State asserts that the trial court erroneously interpreted and applied **[*2]** the tax provision governing the COGS deduction and that, as a matter of law, CGG could not take the COGS deduction. The State also maintains that, in the event CGG is entitled to a COGS deduction at all, because CGG failed to segregate its qualifying costs from its nonqualifying costs, it failed to meet its burden to "conclusively establish that a tax was overpaid and the amount of the overpayment." We will affirm the trial court's judgment.

## DISCUSSION [*3]

This Court has recently provided overviews of the current Texas franchise-tax scheme, originally enacted in 2006, which assesses franchise taxes against a taxable entity's "taxable margin." *See American Multi-Cinema v. Hegar, No. 03-14-00397-CV, 2015 Tex. App. LEXIS 4388, 2015 WL 1967877 (Tex. App.—Austin Apr. 30, 2015, no pet.)* (mem. op.); *Titan Transp., LP v. Combs, 433 S.W.3d 625, 627-29 (Tex. App.—Austin 2014, pet. denied)*; *Combs v. Newpark Res., Inc., 422 S.W.3d 46, 47-48 (Tex. App.—Austin 2013, no pet.)*. The franchise-tax statute has been substantively amended several times since its enactment, and the provisions applicable to this case are those that were in effect on January 1, 2008.[3] Under that version of the franchise-tax statute, after calculating total revenue the taxpayer computed its "taxable margin" by first determining its "margin." *See* Tex. Tax Code § 171.101(a)(1) ("The taxable margin of a taxable entity is computed by . . . determining the taxable entity's margin."). The "margin" is the lesser of (1) 70% of the taxable entity's total revenue or (2) the taxable entity's total revenue minus, at the entity's election, either cost of goods sold, as determined under section 171.1012 (the COGS calculation) or compensation, as determined under section 171.1013 (the compensation calculation). *See* Act of May 19, 2006, 79th Leg., 3d C.S., ch. 1, § 5, 2006 Tex. Gen. Laws 1, 8, *as amended by* Act of June 15, 2007, 80th Leg., ch. 1282, § 11, 2007 Tex. Gen. Laws 4282, 4287 (amended 2013) (current version at Tex. Tax Code § 171.101).[4]

CGG is a "fully-integrated geoseismic" company whose clients are companies that explore for and produce oil and gas. CGG's activities include acquiring seismic data for its clients and processing that data to generate images of the subsurface of the earth that aid in

State of Texas, Glenn Hegar, and Greg Abbott, predecessor to the present Attorney General of the State of Texas, Ken Paxton. Hegar and Paxton have been automatically substituted as appellants pursuant to *Texas Rule of Appellate Procedure 7.2(a)*.

[2] *See* Act of May 19, 2006, 79th Leg., 3d C.S., ch.1, § 5, 2006 Tex. Gen. Laws 1, 8 (amended 2013) (current version at *Tex. Tax Code § 171.101(a)*) (allowing taxpayer to elect to deduct COGS from total revenue); Act of May 19, 2006, 79th Leg., 3d C.S., ch.1, § 5, 2006 Tex. Gen. Laws 1, 13-16, *as amended by* Act of June 15, 2007, 80th Leg., ch. 1282, §§ 14, 15, 2007 Tex. Gen. Laws 4282, 4290-91 (amended 2013) (current version at *Tex. Tax Code § 171.1012*) (governing calculation of COGS deduction).

[3] Citations in this opinion will be to the current **[*4]** version of the Tax Code only when intervening amendments are not relevant to the disposition of the issues on appeal.

[4] Not relevant to this case is the option to use the E-Z computation method to determine margin for taxable entities whose total revenue is $10 million or less. *See* *Tex. Tax Code § 171.1016* (E-Z computation method and rate for taxpayers with no more than $10 million in total revenue).

the clients' efforts to produce oil and gas from onshore and offshore locations. The underlying tax protest concerns CGG's 2008 franchise-tax report, specifically its inclusion of a $567,600,223 COGS deduction in its margin calculation. When calculating its margin for the 2008 tax year, CGG elected to employ the COGS calculation, that is, to determine its margin by subtracting from its total revenue an amount for cost of goods sold, as determined under *section 171.1012*. CGG determined that, under *section 171.1012*, it was entitled to a COGS deduction in the amount of $567,600,223. *See Tex. Tax Code § 171.1012* (governing **[*5]** calculation of COGS deduction).

After conducting a "desk audit," the Comptroller determined that CGG "did not qualify for the cost of goods deduction."[5] The Comptroller characterized CGG as a service provider that could not claim a COGS deduction. Accordingly, the Comptroller defaulted to a 30% flat deduction on $1,052,170,534 of total revenue, applied a 51% apportionment factor and a 1% tax rate to the entire sum, and recalculated CGG's franchise-tax obligation to produce a $1,301,568.86 deficiency for the relevant tax year, having credited CGG's prior payment. CGG paid the assessed deficiency, plus interest, under protest. Along with its protest, CGG submitted a letter to the Comptroller explaining its reasons for including the COGS deduction in its margin calculation.

Thereafter, CGG filed the underlying suit, seeking a refund of amounts paid under protest. *See id. §§ 112.051-.060* (governing tax protest suits). CGG asserted that the costs it included in calculating its COGS deduction were incurred exclusively for the "construction, repair, or industrial maintenance of oil and gas wells, which are real property" and therefore includable in the COGS deduction pursuant to *Tax Code subsection 171.1012(i)*. CGG relied specifically on the third sentence of this subsection, which provides:

> A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance [] of real property is considered to be an owner of that labor or materials *and may include the costs*, as allowed by this **[*7]** section, in the computation of cost of goods sold.

*Id. § 171.1012(i)* (emphasis added). In the alternative, CGG asserted that the audio and visual recordings it sells qualify as "goods" under *section 171.1012(a)(3)(A)* because they are sound recordings, images, or sound intended to be mass-distributed by CGG by selling them to as many customers as possible. *See id. § 171.1012(a)(3)(A)* (including in definition of "goods" sound recordings, images, or sounds intended to be mass-distributed by their creator). The State continued to maintain that CGG provides only services to oil and gas exploration and production companies and does not sell anything that meets the statutory definition of "goods."[6]

[5] The "desk audit" consisted of the Comptroller's auditor reviewing CGG's 2008 franchise-tax report, information CGG posted on its website about its business activities, and CGG's responses to a questionnaire the auditor had sent to CGG with a letter stating that the review was "not an audit" but "[did] not preclude an audit" on the same time period in the future. The auditor did not speak to anyone at CGG or inspect its **[*6]** facilities, equipment, job locations, or business records. Instead, the decision to deny the COGS deduction was based on the auditor's conclusion, after reviewing CGG's responses to the questionnaire and the company's website, that it "appears that the primary business is a service" and that CGG's business activities "appear[] to be related to the service of licensing seismic data, or processing seismic data for customers."

[6] The term "goods" is defined as "real or tangible personal property sold in the ordinary course of business of a taxable entity." *Id. § 171.1012(a)(1)*. "Tangible personal property," however, "does not include (i) intangible property; or (ii) services." *Id. § 171.1012(a)(3)(B)*. The State characterizes CGG as a service provider that cannot claim a COGS deduction.

At trial, the evidence concerning CGG's business operations was essentially uncontrovered. On appeal, the State asserts that the parties are in agreement regarding the work CGG actually performs, but that the State and CGG disagree **[*8]** "as to what statutory label should apply to its business activities." CGG counters that, while its position is that it does produce and sell "goods," that question is ultimately irrelevant because it is entitled to take the COGS deduction by virtue of the fact that it "furnishes labor and materials to a project for the construction of real property."

The State does not dispute that an oil and gas well constitutes "real property" for purposes of section 171.1012(i). Thus, if CGG furnishes "labor and materials" to a project for the construction of oil and gas wells, it is entitled to include the costs of that labor and materials, as allowed by section 171.1012, in the computation of its cost of goods sold, and deduct that amount from its total revenue to calculate its "margin" for franchise-tax purposes. The parties are in sharp disagreement as to whether CGG does, in fact, furnish labor and materials to projects for the construction of oil and gas wells or, as the State contends, provides only "services" to companies engaged in the exploration and production of oil and gas. The question presented, then, is whether CGG's activities constitute "labor and materials" furnished to a project for the construction of an oil and **[*9]** gas well within the meaning of subsection 171.1012(i).

This Court recently examined the meaning of "labor" as that term is used chapter 171 of the Tax Code. *See* Newpark Res., 422 S.W.3d at 54-57. In *Newpark Resources* we observed:

> Although we agree that the separate listing of services and labor in section 171.1011(g)(3) indicates that they encompass different concepts, the fact that the terms are listed separately does not mean they are mutually exclusive. Furthermore, the fact that section 171.1011(g)(3) indicates that labor and services have distinct meanings does not provide us with clear guidance as to what that distinction is. Neither term is defined in the statute, and the ordinary definitions of labor and services substantially overlap such that both definitions tend to refer to the words interchangeably.

*Id. at 54* (internal citations omitted). We then considered the meaning of the word "labor" in the context of subsection 171.1012(i), a provision we concluded was intended to allow a taxable entity supplying labor or materials to a project for the construction of real property to deduct its labor or material expenses as if they were a cost of goods sold. *Id. at 56*. We held that the term "labor" as used in subsection 171.1012(i) has the same meaning as in section 171.1012 generally, which **[*10]** permits taxable entities to deduct "all direct costs of acquiring or producing" goods, including "labor costs." *Id.* Finally, given the common definition of the term "labor," which encompasses a "wide range of activities, including 'expenditure of physical or mental effort especially when fatiguing, difficult, or compulsory,'" we concluded that the legislature intended section 171.1012 to permit taxable entities to deduct a wide range of labor expenses, including those associated with activities that might also be described as a "service." *Id.* ("We look to the facts of this case to determine whether NES's services, put in the context of Newpark's overall services, qualify as labor for the construction or improvement of real property."). The analytic framework for determining whether a particular "labor cost" is includable as a cost of goods sold under subsection 171.1012(i), therefore, requires determining whether the particular activity is an essential and direct component of the "project for the construction . . . of real property." *Id.* (trial court could reasonably have concluded that removal and disposal of waste material was labor furnished to project for construction of oil and gas well based **[*11]** on trial testimony that this activity was essential to continue drilling of oil and gas well).

The result of this appeal is largely dictated by the following relevant findings of fact of the trial court, which the State does not challenge on appeal:

> FOF 5: CGG's customers are generally oil and gas exploration and production companies.
>
> FOF 6: Customers purchase, license, and use CGG's seismic and sound recordings and images to determine where to explore and drill for oil and gas.
>
> FOF 7: CGG's seismic services and products are an integral, essential, and direct component of the oil and gas drilling process.
>
> FOF 8: In performing seismic work, CGG furnishes labor, including the expenditure of employee effort to acquire seismic data and to create seismic surveys and images.
>
> FOF 9: As a necessary part of the seismic labor furnished by CGG, CGG furnishes materials, such as dynamite, geophones, airguns, marine vessels, and vibroseis trucks.
>
> FOF 10: CGG creates and furnishes seismic sound recordings and images to customers for use in oil and gas drilling projects.

Based on these findings, the trial court concluded that CGG furnished labor and materials to projects for the construction, improvement, **[*12]** remodeling or repair of oil and gas wells within the meaning of *subsection 171.1012(i)*.[7] Unchallenged findings of fact are binding on an appellate court unless the contrary is established as a matter of law or there is no evidence to support the finding. *McGalliard v. Kuhlmann, 722 S.W.2d 694, 696-97 (Tex. 1986)*. The trial court's finding that CGG's seismic services and products are an "integral, essential, and direct component" of the drilling process is amply supported by record evidence. For example, there was evidence that seismic data provides a "roadmap" or "blueprint for the project," which CGG's customers use "as a guide [for] where to drill the wells, [and] how deep to drill the wells." There was also evidence that an oil and gas exploration and production company cannot reasonably go out and drill a well without the information CGG provides. Thus, as we did in *Newpark Resources*, we hold that the trial court in the present case could reasonably have concluded that the seismic data acquisition and processing CGG performs for its oil and gas exploration and production company customers is "labor furnished to a project for the construction of real property."

On appeal, the State argues that the trial court erred in concluding that CGG was entitled to a COGS deduction because, even if CGG's activities qualify as "labor and materials" within the meaning of *subsection 171.1012(i)*, they are too far removed from the construction of an oil and gas well to qualify for that deduction. *See* *Newpark Resources, 422 S.W.3d at 57* ("Admittedly, other cases may present a close issue as to when labor is too far removed from the construction, improvement, remodeling, repair, or industrial maintenance of real property to qualify for the cost-of-goods-sold deduction under *section 171.1012(i)*."). Relatedly, the State argues that subsection *171.1012(i)* is self-limiting, permitting only the

[7] The trial court also concluded that oil and gas wells constitute real property **[*13]** for purposes of subsection *171.1012(i)*, a conclusion of law that the State does not challenge.

deduction of the costs associated with actually furnishing the labor and materials to a project, and does not, as CGG argues, create an alternate pathway for a taxable entity to be treated as producing "goods" and therefore entitled to every type of deduction available under *section 171.1012*.

Implicit in the statutory scheme is that some of a taxable entity's activities in a given case may be of a type that would not qualify as deductible under subsection **[*14]** *171.1012(i)*; that is, they might not constitute an actual *cost of* the labor or materials furnished to a project for the construction of real property. Similarly, there is also a point at which the relationship of a taxable entity's activities to a particular project is so attenuated that the expenses related to those activities may not constitute the costs of furnishing labor and materials *to* that project. However, in this case the State made no attempt in the trial court to make any such distinction regarding CGG's activities. Rather, the State took the position that, as a matter of law, CGG was not entitled to take a COGS deduction *at all*.[8] Thus, the State failed to preserve the argument that while CGG may have been permitted to include some of its expenses in a COGS deduction, it was not entitled to include the entire $567,600,233. The State insists that it need not have attempted to present evidence of which of CGG's expenses were too attenuated to qualify for a COGS deduction because they were all associated only with a "potential project." The State argues that, at the time CGG provides seismic data and processing to its customers, no well construction has actually occurred and **[*15]** there is no existing project to which CGG could furnish any labor or materials. Thus, according to the State, none of CGG's costs were associated with furnishing labor *to* a project. This argument ignores evidence in the record that CGG's surveying can take place before or after a well is drilled and that CGG often engages in what it describes as "4D" projects in which it processes seismic data related to mature, producing fields to identify the location of additional hydrocarbons.

The evidence does not conclusively establish that CGG's seismic data acquisition and processing activities were not, as the trial court found, integral to the drilling process, which the parties do not dispute is a "project for the construction of real property." Consequently, CGG was entitled to elect to take a COGS deduction. On this record, there is sufficient evidence to support the trial court's judgment that CGG was entitled to claim a **[*16]** COGS deduction in the amount of $567,600,223.

## CONCLUSION

Because, on this record, we cannot conclude that the trial court reversibly erred by rendering judgment that CGG could claim a COGS deduction of $567,600,233, we affirm the trial court's judgment.

Scott K. Field, Justice

Before Chief Justice Rose, Justices Pemberton and Field

Affirmed

Filed: March 9, 2016

[8] At trial the State stated that "we're not fighting them on [CGG's costs], except as to whether they're eligible for them." The Comptroller's auditor agreed that he "did not challenge any of the categories or the amounts" reflected on CGG's COGS calculation spreadsheet.

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# Kirby Lake Dev., Ltd. v. Clear Lake City Water Auth.

Supreme Court of Texas

January 19, 2010, Argued; August 27, 2010, Opinion Delivered

NO. 08-1003

**Reporter**

320 S.W.3d 829; 2010 Tex. LEXIS 613; 53 Tex. Sup. J. 1113

KIRBY LAKE DEVELOPMENT, LTD., MITER DEVELOPMENT CO., L.L.C., TAYLOR LAKE, LTD., AND FRIENDSWOOD DEVELOPMENT CO., LTD., PETITIONERS, v. CLEAR LAKE CITY WATER AUTHORITY, RESPONDENT

**Subsequent History:** Released for Publication October 8, 2010.

On remand at, Remanded by *Clear Lake City Water Auth. v. Friendswood Dev. Co., 2011 Tex. App. LEXIS 4184 (Tex. App. Houston 14th Dist., June 2, 2011)*

**Prior History:** **[**1]** ON PETITION FOR REVIEW FROM THE COURT OF APPEALS FOR THE FOURTEENTH DISTRICT OF TEXAS.

*Clear Lake City Water Auth. v. Kirby Lake Dev., Ltd., 274 S.W.3d 41, 2008 Tex. App. LEXIS 5929 (Tex. App. Houston 14th Dist., 2008)*

## Case Summary

### Procedural Posture

Petitioner residential developers had sought a petition for review from the Court of Appeals for the Fourteenth District of Texas, which held, inter alia, that the developers did not state a claim for inverse condemnation against respondent city water authority and which held that the authority was only required to hold one election in which the issue of the developers' reimbursement for water and sewer facilities was included.

### Overview

Each developer entered into a contract with the authority whereby the developers would build water and sewer facilities. Those facilities would be leased to the authority free of charge until a bond sale was approved in an election. A bond authorization measure was placed on a ballot and rejected. On appeal, the court affirmed in part and reversed in part. No inverse condemnation occurred under *Tex. Const. art. I, § 17(a)* because the developers had consented to use of the facilities by the authority with the understanding that the voters might not choose to reimburse them. While *Tex. Water Code Ann. § 49.066* was not a waiver of immunity as its "sue and be sued" language only contemplated the authority's involvement in litigation, *Tex. Loc. Gov't Code Ann. § 271.152* waived immunity because the authority had entered written contracts for the provision of services. Based on the context of the agreements that the authority would lease the facilities without charge until it acquired such portions, the court interpreted "any" bond election to mean "every" bond election. The agreements were, thus, contracts that specified a fixed and determinable term based on an ascertainable event.

### Outcome

The court affirmed the court of appeals' judgment as to the holding that no inverse condemnation occurred. The court reversed as to the remainder of the court of appeals' judgment and remanded for consideration of the remaining issues.

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For Clear Lake City Water Authority, RESPONDENT: Mr. Ramon G. Viada III, Viada & Strayer, The Woodlands TX; Mr. Barry Abrams, Abrams, Scott & Bickley, LLP, Houston, TX; Mr. William E. Schweinle Jr., Schweinle, Parish & Lowerre, P.C., Houston, TX.

For Greater Houston Builders Association, AMICUS CURIAE: Mr. Murry B. Cohen, Akin Gump Strauss Hauer & Feld LLP, Houston, TX.

For Texas Municipal League, AMICUS CURIAE: Ms. Laura F. Hill, Texas Municipal League, Austin, TX.

**Judges:** CHIEF JUSTICE JEFFERSON delivered the opinion of the Court, in which JUSTICE HECHT, JUSTICE WAINWRIGHT, JUSTICE MEDINA, JUSTICE GREEN, JUSTICE JOHNSON, and JUSTICE LEHRMANN joined, and in which JUSTICE WILLETT joined as to all parts except footnote 7. JUSTICE GUZMAN did not participate in the decision.

**Opinion by:** Wallace B. Jefferson

## Opinion

**[*832]** Water lies beneath the surface of today's case, yet our holding is based on a rule of grammar, not capture. The Water Authority must seek voter approval, "in any bond election" it conducts, to sell bonds so that developers--who fronted the cost of the city's water and sewer lines--can be reimbursed. Does "any" bond election mean "every" bond election? Or has the Authority satisfied its obligation by approving the reimbursement proposal in at least one election, even if voters reject the measure? We hold that, in the context of these Agreements, "any" means "every." Our answer to that question, however, matters little unless the Authority is amenable to suit. We hold that it is. When a Water Authority enters into a contract like the one here, it may be sued for failing to fulfill the **[**2]** contract's terms. *See* *TEX. LOC. GOV'T CODE § 271.152*. The Authority's refusal to include a reimbursement measure in every bond election constituted a breach of its contracts with the Developers. Because the Legislature has waived the Authority's immunity from suit for that breach, we reverse in part the court of appeals' judgment and remand the case to that court to consider the Authority's remaining issues. Because we agree with the court of appeals that the Authority's actions did not rise to the level of a taking, we affirm that part of the court of appeals' judgment.

### I. Background

Petitioners are residential developers in the Clear Lake area of greater Houston. [1] Each entered into contracts entitled "Sales Agreement and Lease of Facilities" with the Clear Lake City Water Authority. [2] The Agreements stipulated that the Developers

[1] They are: Kirby Lake Development, Ltd., Miter Development Company, L.L.C., Taylor Lake, Ltd., and Friendswood Development Company, Ltd. ("Developers").

[2] Taylor Lake, Ltd. entered into two of these contracts, four years apart, because the Authority was not immediately able to annex a portion of the property that Taylor Lake sought to develop. *Clear Lake City Water Auth. v. Kirby Lake Dev., Ltd., 123 S.W.3d 735, 740 n.1 (Tex. App.--Houston [14th Dist.] 2003, pet. denied)*.

would build water and sewer facilities according to the Authority's specifications, and that the Developers would lease the facilities to the Authority free of charge until the Authority purchased them. The Authority agreed to reimburse the Developers for 70% of their construction **[*833]** costs once it received voter-approved bond funds. The Authority was not obligated **[**3]** to reimburse the Developers until a bond sale was approved in an election.

The Agreements contain the following pertinent clauses:

> Subject to other terms and provisions hereof, the Developer agrees to sell and the Authority agrees to purchase all completed portions of the Facilities . . . as soon as possible, but not more than 30 days after receipt of bond proceeds legally available and allocated by the Authority for payment therefore . . . .
>
> ***It is expressly acknowledged and agreed by the parties hereto, that the Authority has no existing voter authorization to issue any bonds to pay for the cost of the Facilities, and does not anticipate that funds will be available for such costs without a voter approved bond sale for [**4] such purchase. The Authority intends to call a bond election in the near future but is not obligated to do so, and the Authority cannot predict when, if ever, such an election and bond sale will occur, or when, if ever, the Authority will have other funds available and allocated for the purchase of the Facilities. The Authority shall have the right to purchase the Facilities with funds available from a source other than a bond sale for such purpose, but shall have no obligation to do so. The Authority does agree, however, that it shall include in any bond election it does hold subsequent to the effective date of this Agreement bond authorization in an amount sufficient to pay the purchase price of the Facilities***. [3]
>
> . . . .
>
> The Authority shall have no obligation to obtain approval from the voters of bonds to finance purchase of the Facilities, but if such voter approval is obtained, the Authority shall sell Authority bonds for the purpose of purchasing the Facilities. . . . The Authority agrees to proceed with due diligence to consummate the issuance of such bonds and the acquisition of the Facilities under such circumstances.

In May 1998, as stipulated by the Agreements, the Authority placed a bond authorization measure on the next election ballot. Voters rejected the measure. In October 1998, the Authority again placed a bond measure on the ballot, this time separating it into two parts: a proposal to reimburse the Developers, and another to fund the maintenance of a separate water treatment plant the Authority owned. The voters passed the second proposal but rejected the first. Three of the four Developers (Kirby Lake, Miter, and Taylor Lake) then sued the Authority, alleging that it was obligated to reimburse them anyway. A jury found for the Developers, and the trial court rendered judgment in accordance with that verdict. *Clear Lake City Water Auth. v. Kirby Lake Dev., Ltd., 123 S.W.3d 735, 741-42 (Tex. App.--Houston [14th Dist.] 2003, pet. denied)* ("*Kirby Lake I*"). The court of appeals reversed, holding that voter approval was a condition precedent to the Authority's purchase obligation. *Id. at 756*.

The Authority held another bond election in September 2004. This time it omitted the Developers' reimbursement proposition

[3] This section appears in bold and italics in all but one of **[**5]** the Agreements.

altogether, citing the

> language of the opinion rendered by the Fourteenth **[**6]** Court of Appeals . . . , which expressly stated that certain of the Developers' contracts merely required "that the developers be included in any subsequent election, and they were"-- **[*834]** confirming that any obligation to seek voter approval to issue bonds to reimburse [the Developers] has already been satisfied.

The Developers sued again, alleging that the Authority breached its agreement to include a reimbursement provision in each bond election. [4] On motion for summary judgment, the trial court concluded that the Authority breached the agreement and awarded damages. *274 S.W.3d at 42* ("*Kirby Lake II*"). The court of appeals rejected the Authority's argument that it was immune from suit, holding that *Local Government Code section 271.152* waived the Authority's immunity. *Id. at 44* (citing *Friendswood I, 256 S.W.3d at 751*). Nonetheless, the court of appeals reversed the trial court's judgment, holding that the Authority complied with the contract because "the balance of the paragraph [in the Agreements] clearly indicates that only one election was contemplated. . . . We therefore find the agreement to be unambiguous in obligating the Water Authority to place the measure only on the next ballot **[**7]** after the effective date of the agreement." *Id. at 46*.

Kirby, Miter, and Taylor also alleged that the Authority's continued possession of the facilities constituted a taking. *321 S.W.3d 1, 2008 Tex. App. LEXIS 5887, at *1* ("Kirby Lake III"). [5] The Authority then filed a plea to the jurisdiction, arguing, among other things, that Kirby, Miter, and Taylor consented to the alleged taking. *Id. at *2*. The trial court granted the plea and dismissed the takings claim for lack of jurisdiction. *Id*. The court of appeals agreed, finding that the Developers had consented to the Authority's possession of the facilities--barring an inverse condemnation claim. *Id. at *13*. Each of these cases was decided by a different panel of the same court of appeals.

In November 2006, while the above **[**8]** cases were pending in the trial court, the Authority held another bond election that called for reimbursing the Developers. The 2006 election proved more contentious than its predecessors. The Authority's board members--including members who had signed the original contracts--actively discouraged passage of the measures. A front-page article in the local paper quoted board members as opposing the bonds. An Authority Newsletter denied any obligation to conduct future bond elections, but said "[n]evertheless, the Board finds it appropriate at this time to submit the issue to the voters for a third time, so that the will of the people, which is an express condition of the contracts, can be heard." The bond measures failed--an outcome that the Developers claim would not have occurred absent the Authority's intermeddling.

We consolidated *Friendswood II*, *Kirby Lake II*, and *Kirby Lake III*, *Kirby Lake Dev., Ltd. v. Clear Lake City Water Auth., 52 Tex. Sup. Ct. J. 788, 788-89 (May 29, 2009)*, and granted the petition for review, *Kirby Lake Dev., Ltd. v. Clear Lake City Water Auth.*, 53 Tex. Sup. Ct. J. 15, 15 (Oct. 23, 2009). The Developers maintain that the court of appeals erred in holding that **[**9]** "any bond election" meant only one election. They also allege that the

[4] Friendswood Development sued separately from the other developers. *2008 Tex. App. LEXIS 9127, at *1* ("*Friendswood II*").

[5] That claim, initially part of *Kirby Lake II*, had to be refiled in the Harris County Civil Court at Law. *See* ***TEX. GOV'T CODE § 25.1032(c)*** ("A county civil court at law has exclusive jurisdiction in Harris County of eminent domain proceedings, both statutory and inverse, regardless of the amount in controversy.").

Authority's perpetual use of the property without compensation constitutes inverse condemnation. **[*835]** The Authority argues, among other things, that neither *section 49.066 of the Water Code* nor *section 271.152 of the Local Government Code* waives its immunity, and that it has fully satisfied its obligations under the Agreements.

## II. An Overview of Water Management in Texas

### A. History

Texas' first venture into water regulation stemmed from the state's need to irrigate its driest regions. *See generally F. Joyce Cox, The Texas Board of Water Engineers*, 7 TEX. L. REV. 86, 86 (1928-1929) ("In Texas, as elsewhere, administrative control of water resources came in answer to a need."). In 1889, the Legislature enacted a bill for "the arid districts of Texas." *See* Act of March 19, 1889, 21st Leg., ch. 88, 1889 Tex. Gen. Laws 100, 100. The goal was to charter corporations that would build an infrastructure to furnish "water to all persons . . . for irrigation and domestic uses." *Id.; see also Ward County Irrigation Dist. No. 1 v. Red Bluff Water Power Control Dist., 170 S.W.3d 696, 700 (Tex. App.--El Paso 2005, no pet.)*. Fifteen years **[**10]** later, Texans approved a constitutional amendment permitting local governments to issue bonds for water development. *TEX. CONST. art. III, § 52(b)(2)*.

Texas voters ratified another water-related amendment in 1917. *See TEX. CONST. art. XVI, § 59*. The amendment created "conservation and reclamation districts" as units of local government, and made the preservation of natural resources a public right and duty. *Id. § 59(a),(b)*; *see also Dallas County Levee Dist. No. 2 v. Looney, 109 Tex. 326, 207 S.W. 310, 310 (Tex. 1918)*. As with prior amendments, financing was instrumental to water-resource management. In that respect, the amendment permitted "all such indebtedness as may be necessary to provide all improvements and the maintenance thereof requisite to the achievement of the purposes of this amendment," as long as "such proposition shall first be submitted to the qualified . . . voters of such district and the proposition adopted." *TEX. CONST. art. XVI, § 59(c)*.

Along with the development of conservation districts came the Legislature's codification of state water law. *See TEX. WATER CODE § 1.003* (declaring "the public policy of the state to provide for the conservation and development of the state's **[**11]** natural resources"). Chapters 49 and 51 of the Water Code govern "water control and improvement districts" ("WCIDs"), like Clear Lake City Water Authority. Chapter 49 provides a blueprint for creating and operating general law water districts, and for financing the significant work required to conserve water resources. *See id. § 49.211(b)*. Chapter 51 deals with WCIDs. *See id. § 51.121*. WCIDs have broad authority to "supply and store water for domestic, commercial, and industrial use; to operate sanitary wastewater systems; and to provide irrigation, drainage, and water quality services." TEXAS COMMISSION ON ENVIRONMENTAL QUALITY, TEXAS WATER DISTRICTS: A GENERAL GUIDE 2 (2004), available at *http://www.tceq.state.tx.us/files/gi-043.pdf_4419598.pdf* (all Internet materials as visited August 25, 2010 and available in Clerk of Court's file).

WCIDs are one of thirteen different types of general law water districts acting as state political subdivisions. *See TEX. WATER CODE §§ 50-68*; Bonnie M. Stepleton, Note, *Texas Groundwater Legislation: Conservation of Groundwater or Drought by Process*, 26 NAT. RESOURCES J. 871, 874 (1986). WCIDs may consist of a single county or multiple counties.

*See* **[**12]** Dick Smith, *Water Control and Improvement Districts*, 6 THE NEW HANDBOOK OF TEXAS 840 (1996). Because WCIDs have **[*836]** extensive power to regulate domestic and commercial water supply, they have become "the main financing mechanism for development in urban areas." Stepleton, 26 NAT. RESOURCES J. at 875.

**B. Clear Lake City Water Authority**

The Clear Lake City Water Authority was created in 1963. See Act of May 6, 1963, 58th Leg., H.B. No. 1003, R.S., ch. 101, 1963 Tex. Gen. Laws 164, 173. The Authority occupies the Clear Lake area in Harris County, approximately 20 miles southeast of downtown Houston. CLEAR LAKE CITY WATER AUTHORITY, GENERAL INFORMATION (2010), *http://clcwa.org/generalinfo.htm*. It is currently Texas' largest water district, encompassing over 16,000 acres, with around 84,000 residents. *Id*.

Water districts frequently contract with private developers to build and maintain water facilities. "Prefunding agreements," like the ones at issue here, are governed by the Texas Commission on Environmental Quality's ("TCEQ") rules. *See Malcomson Rd. Util. Dist. v. Newsom, 171 S.W.3d 257, 274 n.11 (Tex. App.--Houston [1st Dist.] 2005, pet. denied)*; *30 TEX. ADMIN. CODE § 293.46*. These agreements **[**13]** allow developers to finance facilities "contemplated for purchase by the district" before TCEQ has approved the bond issue, provided certain conditions are met. *30 TEX. ADMIN. CODE § 293.46*. The TCEQ rules require developers to pay at least 30% of the costs under such contracts, "to insure the feasibility of the construction projects of such districts." *30 TEX. ADMIN. CODE § 293.47*. The rules further provide that "[a] person proceeding with construction of a project prior to its formal approval by the commission shall do so with no assurance that public funds will be authorized for acquiring the facilities." *Id*. *§ 293.46(6)*. Thus, the developer who builds the infrastructure assumes the risk that funding will never materialize, and voters determine whether to commit funds for the project.

We turn now to the issues before us.

**III. Government Immunity**

Water Control and Improvement Districts are "valid and existing governmental agencies and bodies politic." *Willacy Cnty. Water Control & Improv. Dist. No. 1 v. Abendroth, 142 Tex. 320, 177 S.W.2d 936, 937 (Tex. 1944)* (quotations omitted). As such, they enjoy governmental immunity from suit, unless immunity is expressly waived. *Reata Constr. Corp. v. City of Dallas, 197 S.W.3d 371, 374 (Tex. 2006)*. **[**14]** The Developers argue that both *Texas Water Code section 49.066* and *Texas Local Government Code section 271.152* waive the Authority's immunity. The court of appeals in the Developers' two contract-based cases held that, while *section 49.066* does not waive immunity, *section 271.152* does. *2008 Tex. App. LEXIS 9127, at *2 n.2* (citing *Friendswood I, 256 S.W.3d at 747 n.14*) [6]; *274 S.W.3d at 44*. We agree for the following reasons.

**A. *Water Code section 49.066***

*Section 49.066(a)* provides that "[a] district **[**15]** may sue and be sued in the **[*837]** courts of this state in the name of the district by

[6] The *Friendswood II* court deferred to its prior holding in *Friendswood I* with regard to the issue of immunity. *See 2008 Tex. App. LEXIS 9127, at *2* ("The issues regarding governmental immunity are the same as those in the prior interlocutory appeal in this case. Absent (1) a decision from a higher court or this court sitting en banc that is on point and contrary to the prior panel decision or (2) an intervening and material change in the statutory law, this court is bound by the prior holding of another panel of this court.") (citations omitted). Assuming without deciding that the issue is before us in *Friendswood II*, we agree with the *Friendswood I* court's determination that immunity is waived.

and through its board. A suit for contract damages may be brought against a district only on a written contract of the district approved by the district's board." TEX. WATER CODE § 49.066(a). As we explained in *Tooke v. City of Mexia*,

> the effect of a "sue and be sued" clause in an organic statute depends on the context in which it is used. The words can mean that immunity is waived, but they can also mean only that a governmental entity, like others, has the capacity to sue and be sued in its own name.

Tooke v. City of Mexia, 197 S.W.3d 325, 337 (Tex. 2006). Standing alone, then, "sue and be sued" does not plainly waive the Authority's immunity.

The Developers argue that section 49.066 "plainly waives a district's immunity" because it specifies how a district may be served with a lawsuit for contract damages, and delineates the mechanisms for enforcing a judgment against it. *See* TEX. WATER CODE § 49.066(a)-(c). In *Harris County Hospital District v. Tomball Regional Hospital*, we held that a "sue and be sued" statute that specified who would represent the district in civil proceedings was not an indication of **[**16]** legislative intent to waive immunity: instead, the phrase merely "anticipates the district's involvement in civil proceedings of some nature at some point, but it does not address immunity from suit." Harris Cnty. Hosp. Dist. v. Tomball Reg'l Hosp., 283 S.W.3d 838, 843 (Tex. 2009).

As the court of appeals in *Friendswood II* reasoned, "the Legislature states that a suit for contract damages may be brought against a district only on a written contract of the district approved by the district's board; however, it does not state that all parties to such contracts may sue the district for breach of these contracts or that immunity from suit as to all such claims is waived." 256 S.W.3d at 743. This interpretation conforms with our holding in *Tooke*, in which we scrutinized similar statutory language providing that the City "may contract and be contracted with, implead and be impleaded in all courts and places and in all matters whatsoever . . . ." Tooke, 197 S.W.3d at 344. We explained that "the provision appears to address the capacity of the City to act as a corporate body, not its immunity from suit. All it *clearly* says is that the City can be sued and impleaded in court *when* suit is permitted, **[**17]** not that immunity is waived for all suits." *Id*. Hence, a statute that contemplates a government entity's involvement in litigation does not "clearly and unambiguously waive" the entity's immunity from suit. *See* Wichita Falls State Hosp. v. Taylor, 106 S.W.3d 692, 697 (Tex. 2003) ("[A] statute that waives the State's immunity must do so beyond doubt . . . .").

The Developers also point to the provision in section 49.066(a) setting forth the "only" conditions under which a contract against a district will be enforceable. *See* TEX. WATER CODE § 49.066(a) ("A suit for contract damages may be brought against a district only on a written contract of the district approved by the district's board."). But such language "does not go as far as waiving immunity from suit, but merely establishes a condition precedent to suit." Travis County v. Pelzel & Assocs., 77 S.W.3d 246, 249 (Tex. 2002); *see also* Farmers State Bank of New Boston v. Bowie County, 127 Tex. 641, 95 S.W.2d 1304, 1306 (Tex. 1936) ("The language of said article indicates that the rejection by the commissioners' court of a claim against the county, or the failure of such court to act on the same, is merely a condition precedent to the filing of **[**18]** a suit to recover thereon."); Bexar Metro. Water Dist. v. Educ. and Econ. Dev. Joint Venture, **[*838]** 220 S.W.3d 25, 31 (Tex. App.--San Antonio 2006, pet. dism'd) ("The language the legislature actually used in amending section

49.066(a) does not 'authorize' a suit against a water district; nor does it expressly waive immunity. Rather, the amendment creates a condition precedent: if a suit for contract damages is otherwise authorized, it may be maintained only if the stated condition is met."). We therefore reject this argument as well.

Since *Tooke*, we have consistently refused to find waivers of immunity implicit in statutory language: there can be no abrogation of governmental immunity without clear and unambiguous language indicating the Legislature's intent do so. *See, e.g.*, *Tomball, 283 S.W.3d at 842-43*; *Lamesa Indep. Sch. Dist. v. Booe, 235 S.W.3d 710, 711 (Tex. 2007)*; *City of Elsa v. M.A.L., 226 S.W.3d 390, 391 (Tex. 2007)*. The present statute is no different. In fact, every court of appeals to interpret section 49.066 after *Tooke* has concluded that the statute does not waive immunity. *See* *Clear Lake City Water Auth. v. MCR Corp., No. 01-08-00955-CV, 2010 Tex. App. LEXIS 2194, at *12 (Tex. App.--Houston [1st Dist.] Mar. 11, 2010, pet. denied)*; **[**19]** *Jonah Water Special Util. Dist., No. 03-06-00626-CV, 2009 Tex. App. LEXIS 7072, at *7 (Tex. App.--Austin, Aug. 31, 2009, no pet.)*; *Boyer, Inc. v. Trinity River Auth. of Tex., 279 S.W.3d 354, 358 (Tex.App.--Fort Worth 2008, pet. denied)*; *Bexar Metro. Water Dist., 220 S.W.3d at 32*; *Valley Mun. Util. Dist. No. 2 v. Rancho Viejo, Inc., No. 13-07-545-CV, 2008 Tex. App. LEXIS 1109, at *11 (Tex. App.--Corpus Christi, Feb. 14, 2008, no pet.)* (mem. op.). Because section 49.066 does not contain a clear and unambiguous waiver, the "sue and be sued" language in 49.066(a) does not on its own abrogate governmental immunity.

**B. *Local Government Code section 271.152***

The Legislature enacted section 271.152 "to loosen the immunity bar so that *all* local governmental entities that have been given or are given the statutory authority to enter into contracts shall not be immune from suits arising from those contracts." *Ben Bolt-Palito Blanco Consol. Indep. Sch. Dist. v. Tex. Political Subdivisions Property/Casualty Joint Self-Ins. Fund, 212 S.W.3d 320, 327 (Tex. 2006)* (quotations omitted). [7] The statute waives immunity from suit for certain contract claims: "A local governmental entity that is authorized **[**20]** by statute or the constitution to enter into a contract and that enters into a contract subject to this subchapter waives sovereign immunity to suit for the purpose of adjudicating a claim for breach of the contract . . . ." *TEX. LOC. GOV'T CODE § 271.152*. The statute defines "contract subject to this subchapter" as "a written contract stating the essential terms of the agreement for providing goods or services to the local governmental entity." *Id.* *§ 271.151(2)*.

The Agreements here are written contracts stating their essential terms. The names of the parties, property at issue, and basic obligations are clearly outlined. *See* *Liberto v. D.F. Stauffer Biscuit Co., 441 F.3d 318, 324 (5th Cir. 2006)* (noting that Texas courts generally construe essential terms of a contract to include "the time of performance, the price to be paid, the work to be done, the service to be **[**21]** rendered, or the property to be transferred"); **[*839]** *Fort Worth Indep. Sch. Dist. v. City of Fort Worth, 22 S.W.3d 831, 846 (Tex. 2000)* (noting that a contract is legally binding "if its terms are sufficiently definite to enable a court to understand the parties' obligations"). The relevant inquiry is whether the Agreements entail the provision of "goods or services" to the Authority.

Chapter 271 provides no definition for

[7] As supporters of the Bill explained, blanket immunity from breach of contract claims "create[d] a fundamentally unfair situation that denie[d] redress, for example, to a contractor who completed a project for a city that refused to pay." House Research Organization, Bill Analysis, Tex. H.B. 2039, 79th Leg., R.S. (2005).

"services," despite the Legislature's definition of the term in other contexts. [8] It appears, generally, that the term is broad enough to encompass a wide array of activities. *See* Van Zandt v. Fort Worth Press, 359 S.W.2d 893, 895 (Tex. 1962) ("In ordinary usage the term 'services' has a rather broad and general meaning. It includes generally any act performed for the benefit of another under some arrangement or agreement whereby such act was to have been performed." (quoting Creameries of Am. v. Indus. Comm'n, 98 Utah 571, 102 P.2d 300, 304 (Utah 1940))); *but see* Berkman v. City of Keene, 311 S.W.3d 523, 527 (Tex. App.--Waco 2009, pet. denied) ("[T]he statute does not apply to contracts in which the benefit that the local governmental entity would receive is an indirect, attenuated **[**22]** one.") (quotations omitted).

The *Friendswood I* court relied on our analysis in *Ben Bolt* to conclude that the "agreement to hire third parties to construct the Facilities and to build the streets, roads, and bridges is . . . sufficient to constitute the provision of services **[**23]** to the Authority." Friendswood I, 256 S.W.3d at 751; *see* Ben Bolt, 212 S.W.3d at 327. In *Ben Bolt*, we liberally construed a government-pooled insurance policy (the "Fund") as encompassing "services" rendered by its members, based on the fact that the Fund's "members elect a governing board, and a board subcommittee resolves claims disputes. To that extent, at least, the Fund's members provide services to the Fund." *Id*. The services provided thus need not be the primary purpose of the agreement. *See* Friendswood I, 256 S.W.3d at 746 n.13 ("[I]n *Ben Bolt*, the Texas Supreme Court concluded that the Legislature had waived immunity under this statute even though the court concluded that the part of the contract on which the plaintiff based its claim did not involve the provisions of good [sic] or services to the local governmental entity.").

We agree with the court of appeals that the Agreements entail services provided directly to the Authority. The Developers contracted to construct, develop, lease, and bear all risk of loss or damage to the facilities, obligations far more concrete than those at issue in *Ben Bolt*. Ben Bolt, 212 S.W.3d at 327. We therefore hold that the Agreements contemplate **[**24]** the provision of services under the statute.

The Authority also argues that the Agreements fall outside chapter 271 because there is no "balance due and owed." *See* TEX. LOC. GOV'T CODE § 271.153(a)(1) (limiting "[t]he total amount of money **[*840]** awarded in an adjudication brought against a local governmental entity for breach of a contract" to "the balance due and owed by the local governmental entity under the contract."). According to the Authority, because the voters have not approved bonds to buy the facilities, the Developers cannot prove that the amount they seek is "due and owed." At least within the context of these Agreements, we disagree. The purpose of section 271.153 is to limit the amount due by a governmental agency on a contract once liability has been established, not to foreclose the determination of whether liability exists. Furthermore, the Agreements do stipulate the amount of reimbursement owed upon approval of bond funds. The existence of a balance "due and owed" is thus incorporated within the contract--a balance that would come

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[8] *See, e.g.*, TEX. BUS. & COM . CODE § 17.45(2) (defining "services" under the Deceptive Trade Practices Act as "work, labor, or service purchased or leased for use, including services furnished in connection with the sale or repair of goods"); TEX. UTIL. CODE § 11.003(19) (defining "service" under the Public Utility Regulatory Act as "any act performed, anything supplied, and any facilities used or supplied by a public utility in the performance of the utility's duties under this title to its patrons, employees, other public utilities, and the public"); *see also* Van Zandt v. Fort Worth Press, 359 S.W.2d 893, 895-96 (Tex. 1962) ("Within the meaning of [lien enforcement] statutes . . . and of exemption statutes, 'services' may be rendered though the actual labor . . . performed by one's employees and by means of his machinery or other equipment . . . ." (quoting Levitt v. Faber, 20 Cal. App. 2d Supp. 758, 64 P.2d 498, 500 (Cal. App. 2d 1937))).

due when voters approve payment in a bond election.

For the above reasons, we agree that section 271.152 waives the Authority's immunity from **[**25]** suit.

## IV. Interpretation of the Agreements

### A. Defining "any"

We disagree, however, with the court of appeals' conclusion regarding interpretation of the word "any" in the following contract provision:

> The Authority intends to call a bond election in the near future but is not obligated to do so . . . . The Authority does agree, however, that it shall include in any bond election it does hold subsequent to the effective date of this Agreement bond authorization in an amount sufficient to pay the purchase price of the Facilities.

The Authority says this provision requires the reimbursement measure be placed on one ballot only, upon which it will have fulfilled its contractual obligation. The Developers, on the other hand, contend the provision requires that the Authority place the measure on *every* bond authorization ballot until the end of time, or until the measure is approved. The court of appeals agreed with the Authority, holding that, although the pertinent sentence "could reasonably be interpreted either way, . . . the balance of the paragraph clearly indicates that only one election was contemplated." *Kirby Lake II, 274 S.W.3d at 46*.

Texas courts defining "any" have generally interpreted **[**26]** it to mean "every." [9] Those decisions, however, have been so rooted in context that they provide little guidance in this case. *See* *Texas Co. v. Schriewer, 38 S.W.2d 141, 144 (Tex. Civ. App.--Waco 1931)* ("The word 'any' is a flexible word that may have any one of several meanings according to its use. . . . **[*841]** Its meaning is often restrained, limited, or influenced by the subject-matter or manner in which it is used."), *aff'd in part, rev'd in part sub nom.* *Smith v. Tex. Co., 53 S.W.2d 774 (Tex. Comm'n App. 1932)*. Accordingly, we will examine the Agreements' grammatical structure, in context.

The Authority and the *Kirby Lake II* court point to the use of singular nouns in the succeeding sentence as indicative that "any" means "one time": "The paragraph's first sentence states that the Water Authority 'intends to call a bond election' but it cannot predict when or if 'such an election . . . will occur.' Unlike 'any,' the words 'a' and 'an' are always singular." *Kirby Lake II, 274 S.W.3d at 46*. However, the fact that "a" and "an" are singular does not foreclose interpreting "any" to mean "each" **[**28]** or "one of all"--both of which would require singular antecedents. *See, e.g.,* *Schriewer, 38 S.W.2d at 145* ("In its broad, distributive sense, the sense in which the word is very frequently used, it may have the meaning of 'all,' 'every,' 'each,' or 'each one of all.'"). The more conventional grammatical meaning of the term, then, suggests that the proposition must be

[9] *See* *Hime v. City of Galveston, 268 S.W.2d 543, 545 (Tex. Civ. App.--Waco 1954, writ ref'd n.r.e.)* ("[T]he word 'any' has been judicially construed to mean: '*each*' or '*every*' or '*all*'. (Black's Law Dictionary, 3rd Ed., p. 119); and particularly in construing statutes, the word 'any' is equivalent to and has the force of '*every*' and '*all*'."); *Branham v. Minear, 199 S.W.2d 841, 846 (Tex. Civ. App.--Eastland 1947, writ ref'd n.r.e.)* ("[M]any cases are collated showing that in construing statutes and other instruments 'any' is equivalent to and has force of 'every' or 'all.' . . . We think that as found **[**27]** by the learned trial court, 'any minerals' as used in the deed in question, undoubtedly meant 'all minerals.'"); *Doherty v. King, 183 S.W.2d 1004, 1007 (Tex. Civ. App.--Amarillo 1944, writ dism'd)* ("When the word 'any' is used in a plural sense it means 'all,' 'all or every,' 'each,' 'each one of all,' or 'every' without limitation.") (quotations omitted); *Texas Co. v. Schriewer, 38 S.W.2d 141, 144-45 (Tex. Civ. App.--Waco 1931)* ("In its broad, distributive sense, the sense in which the word is very frequently used, it may have the meaning of 'all,' 'every,' 'each,' or 'each one of all.'), *aff'd in part, rev'd in part sub nom.* *Smith v. Tex. Co., 53 S.W.2d 774 (Tex. Comm'n App. 1932)*.

included in every bond election the Authority holds, until the voters approve reimbursement.

Moreover, the Developers argue that the Authority ignores the Agreements' overall structure and purpose, which was to construct facilities that the Authority would ultimately purchase ("Subject to other terms and provisions hereof, the Developer agrees to sell and the Authority agrees to purchase all the completed portions of the facilities . . . ."). We agree with the Developers that we must evaluate the overall agreement to determine what purposes the parties had in mind at the time they signed the Agreements. *See* [Don's Bldg. Supply, Inc. v. OneBeacon Ins. Co., 267 S.W.3d 20, 23 (Tex. 2008)](#) ("Effectuating the parties' expressed intent is our primary concern.").

Section 4.01 provides that the Developer shall lease all operable portions **[**29]** of the facilities to the Authority "without charge *until such time as the Authority acquires such portions*; provided that such lease shall terminate upon the acquisition by the Authority of all the Facilities." (Emphasis added.) Had the parties envisioned only one bond election, they could have easily stated that the Authority may lease the facilities until conclusion of that particular election. Instead, the Agreement permits a continued leasehold "until such time as the Authority acquires [the Facilities]." Moreover, the Agreement is silent as to the parties' obligations in the event the bond measure does not pass. While it expressly acknowledges "that the Authority has no *existing* voter authorization to issue any bonds to pay for the cost of the Facilities, and does not anticipate that funds will be available for such costs *without a voter approved bond sale*," it at no point relinquishes the Authority from its obligation "to include [the bond measure] in any bond election it *does* hold." (Emphases added.)

The *Kirby Lake II* court noted that the Agreement "does not state that a bond measure would be submitted to voters repeatedly until approved." 274 S.W.3d at 46. However, assuming **[**30]** that "any" means "every," such additional language would be superfluous, as the Agreement plainly states that the Authority is to include the measure "in any bond election it does hold." The more blatant omission would be the absence of a provision limiting the Authority's perpetual lease of the facilities without charge in the event the measure does not pass.

Unless the Authority were obligated to submit a measure to reimburse the Developers in each bond election, the Developers **[*842]** would have essentially forfeited their interest in facilities they built and paid for. *See* Aquaplex, Inc. v. Rancho La Valencia, Inc., 297 S.W.3d 768, 774 (Tex. 2009) ("Forfeitures are not favored in Texas, and contracts are construed to avoid them."). It is unlikely that the Developers intended to convey water and sewer lines as a gift. Because we conclude that the contract, as a whole, contemplates the eventual sale of the Facilities, and because we construe contracts to avoid forfeiture where possible, we hold that the Agreements require the Authority to submit a bond proposal in every bond election it chooses to hold. *See* Reo Indus., Inc. v. Natural Gas Pipeline Co. of Am., 932 F.2d 447, 454 (5th Cir. 1991) **[**31]** ("Texas courts will not construe a contract to result in a forfeiture unless it cannot be construed in any other way."); Sheppard v. Avery, 89 Tex. 301, 34 S.W. 440, 442 (Tex. 1896) ("A forfeiture of rights of property is not favored by the courts, and laws will be construed to prevent rather than to cause such forfeiture.").

**B. At-will termination of perpetual contracts**

The Authority contends, in the alternative, that the lower court's judgments should be affirmed because the law disfavors perpetual contracts. It is true, as the Authority observes, that the Agreements contain no time limit on its alleged duty to include reimbursement measures in every bond election. We also acknowledge the prospect that voters may never approve such a measure. In [Fort Worth Independent School District v. City of Fort Worth, 22 S.W.3d at 841](), we noted that "contracts which contemplate continuing performance (or successive performances) and which are indefinite in duration can be terminated at the will of either party" (quotations omitted). Yet the Authority ignores the line of cases that distinguish between contracts of indefinite duration and contracts that specify determinable events. *See generally* [Trient Partners I Ltd. v. Blockbuster Entertainment Corp., 83 F.3d 704 (5th Cir. 1996)]() **[**32]** (applying Texas law); [City of Big Spring v. Bd. of Control, 404 S.W.2d 810 (Tex. 1966)]().

Where a contract's language specifies a fixed and determinable term, "the rule of law that a contract may be terminated at the end of a reasonable time does not apply." [Big Spring, 404 S.W.2d at 816]()). *In City of Big Spring v. Board of Control*, the City contracted to provide water to a state-run hospital at a pre-arranged rate for "as long as the State of Texas shall in good faith maintain and operate said hospital." [Big Spring, 404 S.W.2d at 815](). Because this language "fix[ed] an ascertainable fact or event, by which the terms of [the] contract's duration [could] be determined," we held that the contract was not indefinite in duration and therefore not terminable at will. *Id.; see also* [Fluorine on Call, Ltd. v. Fluorogas Ltd., 380 F.3d 849, 856 (5th Cir. 2004)]() (applying Texas law). The Agreements here stipulate that both lease of the facilities and the terms of the Agreements themselves terminate upon the Authority's purchase of the facilities (having attained voter-approved bond funds). "Purchase of the Facilities" is an ascertainable event which both parties can identify; the Agreements are thus **[**33]** not terminable at will. [10]

### [*843] C. Reserved Powers Doctrine

The Authority next argues that, should we interpret the Agreements to impose an ongoing obligation to submit bond proposals in each future election, the Agreements would interfere with substantive government functions, violating the reserved powers doctrine. *See* [State ex rel. City of Jasper v. Gulf States Utils. Co., 144 Tex. 184, 189 S.W.2d 693, 698 (Tex. 1945)](). The Authority maintains that "a contract which purports to bind all future boards of directors to include certain propositions in all future elections would abrogate [its] discretion" regarding its handling of future bond elections. *See* [Todd v. Helton, 495 S.W.2d 213, 220 (Tex. 1973)]() (noting **[**34]** that elections are "essentially the exercise of political power," and exempt from judicial interference); [State ex rel. Edwards v. Reyna, 160 Tex. 404, 333 S.W.2d 832, 833 (Tex. 1960)]() ("[T]he conduct of elections is primarily a matter for legislative regulation and control.").

Certain powers are conferred on government entities "for public purposes, and can neither be delegated nor bartered away." [Jasper, 189 S.W.2d at 698](). Government entities cannot "cede . . . away [such powers] through contracts with others so as to disable them from the performance of their public duties." *Id.; see also* [Brenham v. Brenham Water Co., 67 Tex. 542, 4 S.W. 143, 149 (Tex. 1887)]() ("[Municipal] corporations may make authorized contracts, but they have no power, as a party, to make contracts or pass bylaws which shall cede

[10] We note, too, that the Water Code expressly permits water districts to "enter into contracts, which may be of unlimited duration, with . . . private entities on the terms and conditions the board may consider desirable, fair, and advantageous for . . . the continuing and orderly development of the land and property within the district through the purchase, construction, or installation of works, improvements, facilities, plants, equipment, and appliances . . . ." [TEX. WATER CODE § 49.213(c)(4)]().

away, control or embarrass their legislative or governmental powers, or which shall disable them from performing their public duties.") (quotations omitted). However, it does not apply to the case at hand. Here, the Authority contracted not to bargain away future power, but to pay an invoice for services rendered if and when funds become available through voter-approved bonds.

Nor does the present situation suggest **[**35]** improper impediments to the Authority's governmental operations. In *Clear Lake City Water Authority v. Clear Lake Utilities*, we held that an agreement between the Authority and a utility company was not binding because it had "the effect of potentially controlling and embarrassing [the] Authority in the exercise of its governmental powers." *Clear Lake City Water Auth. v. Clear Lake Utils. Co., 549 S.W.2d 385, 392 (Tex. 1977)*. In that case, the agreement obligated the Authority to meet all water and sewage treatment needs for the Utilities, while precluding it from extending those services directly to the landowners themselves, "under terms and rates that it deems best." *Id*. Thus we found that the Authority had bargained away its governmental power to determine "whether, on any particular date, it is in the best interests of all of its customers and the public in general, to extend water and sewer service to a particular person or entity." *Id*.

In this case, the Authority's contractual obligation to include a bond reimbursement proposition in future elections does not affect the performance of its public duties. It neither hampers nor embarrasses the manner in which the Authority holds **[**36]** elections--including the time, place, order, number of propositions, or even whether it chooses to hold a bond election at all. Nor does it control or impede the Authority's power to determine how and to whom it will extend water services. *See id*. We therefore reject the Authority's contention that the Agreements run afoul of the reserved powers doctrine.

## V. Inverse Condemnation Claim

Finally, Kirby, Miter, and Taylor claim that the Authority's continued, **[*844]** rent-free possession of the Facilities constitutes inverse condemnation. Under the Texas Constitution, no property may "be taken, damaged, or destroyed for or applied to public use without adequate compensation being made, unless by the consent of such person . . . ." *TEX. CONST. art. I, § 17(a)*. This provision, like the *Fifth Amendment to the United States Constitution*, applies not only to traditional takings claims, but also to inverse condemnation claims, in which a property owner alleges that the government has usurped the use and value of his or her property, even if it has not completely appropriated title. *U.S. CONST. amend. V*; *Stevens v. City of Cannon Beach, 510 U.S. 1207, 114 S. Ct. 1332, 127 L. Ed. 2d 679 (1994)*; *Town of Flower Mound v. Stafford Estates L.P., 135 S.W.3d 620, 646 (Tex. 2004)*; **[**37]** *Brazos River Auth. v. City of Graham, 354 S.W.2d 99, 130-31, 163 Tex. 167 (Tex. 1962)*.

A person who consents to the governmental action, however, cannot validly assert a takings claim. *See City of Round Rock v. Smith, 687 S.W.2d 300, 303 (Tex. 1985)* (holding that homeowners did not state a claim for inverse condemnation because their representative "consented to the taking"); *State v. Steck Co., 236 S.W.2d 866, 869 (Tex. Civ. App.--Austin 1951, writ ref'd)*; *Hightower v. City of Tyler, 134 S.W.2d 404, 406 (Tex. Civ. App.--El Paso 1939, writ ref'd)* (rejecting claim that city's use of water and sewer lines was a taking, because "appellants gave consent to the City to make such use of the lines as was made"). Moreover, when a private party contracts with the government, generally "the State does not have the requisite intent under constitutional-takings jurisprudence when it withholds property or money from an entity in a contract dispute." *General Servs. Comm'n v. Little-Tex Insulation Co. Inc., 39 S.W.3d 591, 598-99 (Tex. 2001)*. Instead, "the State is acting within a color of right under the contract and not under its eminent domain powers." *Id. at 599* (noting that, in such cases, the State acts "akin **[**38]** to a private citizen and not under any sovereign powers"); *see also J.J. Henry Co. v. U.S., 411 F.2d 1246, 1249, 188 Ct. Cl. 39 (Ct. Cl. 1969)* ("The clear thrust of the authorities is that where the government possesses property under the color of legal right, as by an express contract, there is seldom a taking in violation of the *Fifth Amendment*.").

We agree with the *Kirby Lake III* court, which observed that the Developers consented to any alleged taking when they "agreed to allow the Authority to lease and use the Facilities free of charge until the Authority purchases the Facilities." *321 S.W.3d 1, 2008 Tex. App. LEXIS 5887, at *12-*13* (concluding that the Developers' allegations affirmatively negated jurisdiction). As the court noted, the Developers "treated the Agreements as still in effect by continuing to demand performance . . . and suing to enforce the Agreements"; [11] thus, the Authority was acting under colorable contract rights and did not have the requisite intent to take the Developers' facilities under any eminent domain powers. *See Little-Tex., 39 S.W.3d at 599*. Accordingly, the Developers' inverse condemnation claim is barred.

## VI. Conclusion

In sum, we affirm the **[**39]** court of appeals' judgment in *Kirby Lake III*, which held the Developers did not state a claim for inverse condemnation. *TEX. R. APP. P. 60.2(a)*. With respect to *Kirby Lake II* and *Friendswood II*, we reverse the court of appeals' judgments and remand to that **[*845]** court to consider the Authority's remaining issues. *Id.* *60.2(d)*.

/s/ Wallace B. Jefferson

Wallace B. Jefferson

Chief Justice

OPINION DELIVERED: August 27, 2010

[11] *321 S.W.3d 1, 2008 Tex. App. LEXIS 5887, at *14*.

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# *Peterson Produce Co. v. United States*

United States Court of Appeals for the Eighth Circuit

February 21, 1963

No. 17158

**Reporter**

313 F.2d 609; 1963 U.S. App. LEXIS 6071; 63-1 U.S. Tax Cas. (CCH) P9301; 11 A.F.T.R.2d (RIA) 892

PETERSON PRODUCE COMPANY, an Arkansas Corporation, Appellant, v. UNITED STATES of America, Appellee

## Case Summary

### Procedural Posture

Appellant taxpayer sought review of a United States District Court judgment that appellant could not recover income taxes paid for the taxable year ending August 31, 1956, by virtue of an alleged net operating loss carry-back to 1956 from its taxable year that ended March 31, 1959.

### Overview

Appellant taxpayer claimed a refund by virtue of an alleged net operating loss carry-back to 1956. Appellant engaged in the feed and hatchery business. Appellant began a small breeding farm operation in 1946. The breeding farm operations became increasingly difficult to maintain so appellant established a broiler division. Appellant used an accrual method of accounting, but appellant alleged the breeding operation was reported on a cash basis and later reported the broiler division on a cash basis. The federal agency denied appellant's request for a carry-back loss for 1956 because the taxpayer was not entitled to use the cash method of accounting without obtaining the prior permission of the federal agency because the broiler division did not constitute a new, distinct and separate business so as to allow a departure from the accounting method thus far consistently employed. It was further felt that such a departure could be used to distort income. The court agreed with the conclusions above and the fact that there was no proof in the record that the breeding farm always operated on a cash basis or that it was more closely related to the breeding farm than to the other divisions.

### Outcome

The lower court's judgment that disallowed appellant's request for recovery of income for an alleged net operating loss carry-back was affirmed because appellant changed its accounting method without appellee's approval and the broiler division was not a new, distinct and separate division, so as to allow a departure from the accounting method thus far consistently employed and such a departure could have been used to distort income.

**Counsel:** **[**1]** W. H. Enfield of Little & Enfield, Bentonville, Ark., for appellant.

Richard J. Heiman, Attorney, Dept. of Justice, Washington, 25, D.C., Louis F. Oberdorfer, Asst. Atty. Gen., Washington, D.C., Lee A. Jackson, Harry Baum, Richard J. Heiman, Attorneys, Dept. of Justice, Washington, D.C., and Charles M. Conway, U.S. Atty., and Robert E. Johnson, Asst. U.S. Atty., Fort Smith, Ark., on the brief, for appellee.

**Judges:** Before VOGEL, BLACKMUN and

RIDGE, Circuit Judges.

**Opinion by:** VOGEL

## Opinion

**[*610]** Appellant-taxpayer, Peterson Produce Company, brought this action to recover income tax paid for the taxable year ending August 31, 1956. The appellant claimed refund by virtue of an alleged net operating loss carry-back to 1956 from its taxable year ended March 31, 1959.

The appellant was incorporated in 1947 and is engaged in the feed and hatchery business. Between 1947 and September, 1958, a substantial part of the taxpayer's business consisted of the sale of chicks, feed, and other poultry supplies to growers and participation by it in raising and selling the chickens. In the years immediately following the incorporation appellant operated by taking chattel mortgages on the **[**2]** grower's flocks as security for such supplies. This method was gradually discontinued and by about 1956 very few chattel mortgages were being taken. Instead appellant established contractual relationships with the growers which were basically profit-sharing plans in which the grower's share depended heavily upon the amount of feed used per pound of meat produced. Under these arrangements the taxpayer had no direct authority over the growers, although it did maintain field men who called upon the growers and who did exercise some persuasive control over them.

Appellant also began a small breeding farm operation in 1946. This was later separately incorporated through a tax-free spin-off under the name Peterson Breeding Farm, Inc.

Testimony indicated that it became increasingly difficult for the taxpayer to maintain the chick raising part of the business on profitable scale. The growers were no longer willing to take the risk of raising the chicks on their own. As a result appellant entered a new phase of the business in September, 1958, when there was established the broiler division. It began broiler raising by hiring the growers to raise taxpayer's broilers on a labor and **[**3]** lease agreement. Under such a system the taxpayer was able to retain complete control over the care, feeding and time for marketing of the chicks that were supplied. Under the new arrangement the taxpayer, rather than the growers, was considered the owner of the chicks. These non-profit-sharing lease contracts largely supplanted the former profit-sharing plans and what had once been essentially a debtor-creditor relationship now became what could more accurately be termed a master-servant arrangement.

Prior to September 1, 1958, the taxpayer had reported income from the overall operations using the accrual method of accounting. It does contend, however, that the breeding operation had been reported on a cash basis. Following the development of the broiler division, the appellant continued to report income from the feed and hatchery divisions on the accrual method, but reported the income from the broiler division on a cash basis. The feed and chicks 'sold' to the broiler division by the feed and hatchery departments were transferred on the latter's books at cost and as accounts receivable. The broiler division, by using the cash method, would deduct as a cost item at the close **[**4]** of the taxable year the amounts expended in processing the chicks unsold at the time the return was filed.

Daily transactions were recorded in the original journals and at the end of each month were posted in the single general ledger wherein it was possible to separate the accounts of the broiler division. At all times the appellant maintained a single bank account for all three divisions. Administrative costs of the various divisions were distributed among the three divisions on a pro rata scale.

**[*611]** Operating under the above-described dual accounting system, the taxpayer claimed the carry-back loss to the year 1956. This loss was denied by the Commissioner. In resisting taxpayer's suit to recover, the government contends that the taxpayer was not entitled to use the cash method of accounting without obtaining the prior permission of the Commissioner because the broiler division did not constitute a new, distinct and separate business so as to allow a departure from the accounting method thus far consistently employed. It was further felt that such a departure could easily be used to distort income. By disallowing the cash method of accounting in the broiler division, **[**5]** the latter was required to carry the chicks and feed acquired from the feed and hatchery division as a closing inventory rather than as a cash expenditure, thus resulting in the deficiency in question.

In suing for recovery of the alleged deficiency, the taxpayer contended and does contend here that: The broiler division was a new, separate and distinct business; that its status as a farmer was material to the issue; that there was no attempt to change the method of accounting insofar as it had always reported its income from the breeding farm on a cash basis; that it kept complete and separable books and records for the broiler division; and, finally, that there was no distortion of income through the use of the dual system of accounting.

The District Court, in its opinion published at *205 F.Supp. 229*, held that: It was immaterial whether or not taxpayer be considered a farmer since this would not affect its right to change its accounting system; that the over-all operations of taxpayer did not undergo a significant change; that all three departments were too interdependent and well-integrated to be considered separate and distinct; that there was not a sufficient **[**6]** separation of the books and records; that regardless of how the above issues were resolved, there was not a clear reflection of income for the year in question through the method employed by the taxpayer; and finally there existed the possibility of a transfer of a large quantity of feed and chicks toward the end of a profitable year, thus decreasing the closing inventory of the feed and hatchery divisions and increasing the cash deductions of the broiler department. Such a procedure could be employed to distort the true net income from the over-all operations.

We have carefully examined the record. The inescapable conclusion must be that there were involved questions of fact and that the District Court's findings were well supported and manifestly correct. While the court below did not consider the question raised here as to the consistency of the cash method now employed by the broiler division with that of the breeding farm operation, we cannot see how that additional contention aids the taxpayer. Initially, nothing appears in the record to substantiate the contention that the breeding farm had always operated on a cash basis. But assuming, arguendo, that the breeding farm **[**7]** had consistently operated on the cash method, there is nevertheless nothing to support a proposition that the broiler division was more closely related to the breeding farm than to the feed and hatchery departments. Certainly, the broiler division was an obvious outgrowth of the former feed and hatchery relationship with the growers, and the 'new' broiler division did not have any more connection with the breeding farm than the prior arrangements had had.

We can see no value in further reiterating or attempting to enlarge upon the trial court's carefully considered opinion covering taxpayer's other contentions and we affirm on the basis thereof.

Finally, the taxpayer contends in the alternative that the case should be sent back to the District Court for recalculation of the deficiency. It is stated that the deficiency was arrived at by the use of the cost of the inventory and that the market value should have been used since the latter was lower. The appellant did not raise this point below and accordingly it would, ordinarily, be **[*612]** improper for this court to give primary consideration thereto. See *Helvering v. Rubinstein, 8 Cir., 1942, 124 F.2d 969, 972-973*. **[**8]** Nevertheless, while it is true that the appellant had regularly used the lower of cost or market value in calculating its inventories, we can find no indication in the record that the market value was below cost. Additionally, the figures used by the government in computing the closing inventory were those submitted by taxpayer's accountant and he calculated such figures at cost, the basis upon which the items were transferred from the feed and hatchery divisions. We can see no merit in appellant's alternative prayer for relief.

Affirmed.

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# PPL Corp. v. Comm'r

Supreme Court of the United States

February 20, 2013, Argued; May 20, 2013, Decided

No. 12-43

**Reporter**

133 S. Ct. 1897; 185 L. Ed. 2d 972; 2013 U.S. LEXIS 3979; 81 U.S.L.W. 4311; 2013-1 U.S. Tax Cas. (CCH) P50,335; 111 A.F.T.R.2d (RIA) 1955; 24 Fla. L. Weekly Fed. S 202; 2013 WL 2149792

PPL CORPORATION AND SUBSIDIARIES, Petitioners v. COMMISSIONER OF INTERNAL REVENUE

**Notice:** The LEXIS pagination of this document is subject to change pending release of the final published version.

**Prior History:** **[***1]** ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

*PPL Corp. v. Comm'r, 665 F.3d 60, 2011 U.S. App. LEXIS 25551 (3d Cir., 2011)*

**Disposition:** *665 F.3d 60*, reversed.

## Case Summary

### Procedural Posture

Petitioner domestic corporate taxpayer brought an action challenging the determination of respondent Commissioner of Internal Revenue which disallowed the taxpayer's claimed credit under *26 U.S.C.S. § 901(b)(1)* for a windfall tax imposed by the United Kingdom (U.K.). Upon the grant of a writ of certiorari, the taxpayer appealed the judgment of the U.S. Court of Appeals for the Third Circuit which held that the tax was not creditable.

### Overview

The U.K. privatized government-owned companies which became significantly profitable, and the U.K. subsequently imposed the windfall tax to account for the amount the U.K. should have received for the companies. The taxpayer, which was part owner of a privatized company, claimed credit for the windfall tax it was required to pay as a foreign excess profits tax, but the Commissioner contended that the windfall tax was a valuation adjustment which was not creditable. The U.S. Supreme Court unanimously held that the windfall tax was creditable under *§ 901(b)(2)* as an excess profits tax. The windfall tax's controlling predominant character was that of a U.S. tax on income as a foreign tax which reached the taxpayer's profits, regardless of the manner in which the U.S. characterized the tax. The windfall tax was a tax on realized net income disguised by the U.K. as a tax on the difference between the price the taxpayer paid for its interest in the privatized company and the fictitious value of the company which was calculated using an imputed price-to-earnings ratio.

### Outcome

The judgment holding that the windfall tax was not creditable was reversed. Unanimous Decision; 1 Concurrence.

## Syllabus

**[*1898]** In 1997, the United Kingdom (U.K.), newly under Labour Party rule, imposed a one-time "windfall tax" on 32 U.K. companies privatized between 1984 and 1996 by the Conservative government. The companies had been sold to private parties through an initial sale of shares, known as a "flotation." Some of the companies were required to continue **[**975]** providing services for a fixed period at the same rates they had offered under government control. Many of those companies became dramatically more efficient and earned substantial profits in the process.

Petitioner PPL Corporation (PPL), part owner of a privatized U.K. company subject to the windfall tax, claimed a credit for its share of the bill in its 1997 federal income-tax return, relying on *Internal Revenue Code §901(b)(1)*, which states that any "income, war profits, and excess profits taxes" paid overseas are creditable against U.S. income taxes. *Treasury Regulation §1.901-2(a)(1)* interprets this section to mean that a foreign tax is creditable if its "predominant character" "is that of an income tax in the U.S. sense." The Commissioner **[***2]** of Internal Revenue (Commissioner) rejected PPL's claim, but the Tax Court held that the U.K. windfall tax was creditable for U.S. tax purposes under *§901*. The Third Circuit reversed.

*Held:* The U.K. tax is creditable under *§901*. *Pp. ___ - ___, 185 L. Ed. 2d, at 978-983*.

(a) *Treasury Regulation §1.901-2*, which codifies longstanding doctrine dating back to *Biddle v. Commissioner, 302 U.S. 573, 578-579, 58 S. Ct. 379, 82 L. Ed. 431 (1938)*, provides the relevant legal standard. First, a tax's "predominant character," or the normal manner in which a tax applies, is controlling. See *id., at 579, 58 S. Ct. 379, 82 L. Ed. 431*. Thus, a foreign tax that operates as an income, war profits, or excess profits tax for most taxpayers is generally creditable. Second, foreign tax creditability depends not on the way a foreign government characterizes its tax but on whether the tax, if enacted in the U.S., would be an income, war profits, or excess profits tax. See *§1.901-2(a)(1)(ii)*. Giving further form to these principles, *§1.901-2(a)(3)(i)* explains that a foreign tax's predominant character is that of a U.S. income tax "[i]f . . . the foreign tax is likely to reach net gain in the normal circumstances in which it applies." Three tests set forth in the regulations provide guidance in **[***3]** making this assessment, see *§1.901-2(b)(1)*. The tests indicate that net gain consists of realized gross receipts reduced by significant costs and expenses attributable to such gross receipts, in combination known as net income. A foreign tax that reaches net income, or profits, is creditable. *Pp. ___ - ___, 185 L. Ed. 2d, at 978-979*.

**[*1899]** (b) The U.K. windfall tax's predominant character is that of an excess profits tax, a category of income tax in the U.S. sense. The Labour government's conception of "profit-making value" as a backward-looking analysis of historic profits is not a typical valuation method. Rather, it is a tax on realized net income disguised as a tax on the difference between two values, one of which is a fictitious value calculated using an imputed price-to-earnings ratio. The substance of the windfall tax confirms this conclusion. When rearranged, the U.K's formula demonstrates that the windfall tax is economically equivalent to the difference between the profits each company *actually* earned and the amount the Labour government believed it *should* have earned given its flotation value. For most of the relevant companies, the U.K. formula's substantive effect was to impose a 51.71 percent tax on all **[***4]** profits above a threshold, a classic excess profits tax. The Commissioner claims that any algebraic rearrangement is improper because U.S. courts must take **[**976]** the foreign tax rate as written and accept whatever tax base the foreign tax purports to adopt. But such a rigid construction cannot be squared with the black-letter principle that "tax law deals in economic realities, not legal abstractions." *Commissioner v. Southwest Exploration Co., 350 U.S. 308, 315, 76 S. Ct. 395, 100 L. Ed. 347, 134 Ct. Cl. 903, 1956-1 C.B. 614*Given the artificiality of the U.K.'s calculation method, this Court follows substance over form and recognizes that the windfall tax is nothing more than a tax on actual profits above a threshold. *Pp. ___ - ___, 185 L. Ed. 2d, at 979-982*.

(c) The Commissioner's additional arguments in support of his position are similarly unpersuasive. *Pp. ___ - ___, 185 L. Ed. 2d, at 982-983*.

*665 F.3d 60*, reversed.

**Counsel: Paul D. Clement** argued the cause for petitioners.

**Ann O'Connell** argued the cause for respondent.

**Judges:** Thomas, J., delivered the opinion for a unanimous Court. Sotomayor, J., filed a concurring opinion.

**Opinion by:** THOMAS

## Opinion

Justice **Thomas** delivered the opinion of the Court.

In 1997, the United Kingdom (U.K.) imposed a one-time "windfall tax" on 32 U.K. companies privatized between 1984 and 1996. This case addresses whether that tax is creditable for U.S. tax purposes. [1] *Internal Revenue Code §901(b)(1)* states **[***5]** that any "income, war profits, and excess profits taxes" paid overseas are creditable against U.S. income taxes. *26 U.S.C. §901(b)(1)*. Treasury Regulations interpret this section to mean that a foreign tax is creditable if its "predominant character" "is that of an income tax in the U.S. sense." *Treas. Reg. §1.901-2(a)(1)(ii)*, *26 CFR §1.901-2(a)(1) (1992)*. Consistent with precedent and the Tax Court's analysis below, we apply the predominant character test using a commonsense approach **[*1900]** that considers the substantive effect of the tax. Under this approach, we hold that the U.K. tax is creditable under *§901* and reverse the judgment of the Court of Appeals for the Third Circuit.

I

A

During the 1980's and 1990's, the U.K.'s Conservative Party controlled Parliament and privatized a number of government-owned companies. These companies were sold to private parties through an initial sale of shares, known as a "flotation." As part of privatization, many companies were required to continue providing services at the same rates they had offered under government control for a fixed period, typically their first four years of private operation. As a result, the companies could only increase **[***6]** profits during this period by operating more efficiently. Responding to market incentives, many of the companies became dramatically more efficient and earned substantial profits in the process.

The U.K.'s Labour Party, which had unsuccessfully opposed privatization, used the companies' profitability as a campaign issue against the Conservative Party. In part because of campaign promises to tax what it characterized as undue profits, the Labour Party defeated the Conservative Party at the polls in 1997. Prior to coming to power, Labour Party leaders hired accounting firm Arthur Andersen to structure a tax that would capture excess, or "windfall," profits earned during the initial years in **[**977]** which the companies were prohibited from increasing rates. Parliament eventually adopted the tax, which applied only to the regulated companies that were prohibited from raising their rates. See Finance (No. 2) Act, 1997, ch. 58, pt. I, cls. 1 and 2(5) (Eng.) (U.K. Windfall Tax Act). It imposed a 23 percent tax on any "windfall" earned by such companies. *Id.*, cl. 1(2). A separate schedule "se[t] out how to quantify the windfall from which a company was benefitting." *Id.*, cl. 1(3). See *id.*, sched. **[***7]** 1.

In the proceedings below, the parties stipulated that the following formula summarizes the tax imposed by the Labour Party:

Tax = 23% [(365 x (P / D) x 9) - FV]

D equals the number of days a company was subject to rate regulation (also known as the "initial period"), P equals the total profits earned during the initial period, and FV equals the flotation value, or market capitalization value after sale. For 27 of the 32 companies subject to the tax, the number of days in the initial period was 1,461 days (or four years). Of the remaining five companies, one had no tax liability because it did not earn any windfall profits. Three had initial periods close to four years (1,463, 1,456, and 1,380 days). The last was privatized shortly before the Labour Party took power and had an initial period of only 316 days.

The number 9 in the formula was characterized as a price-to-earnings ratio and was selected because it represented the lowest average price-to-earnings ratio of the 32 companies subject to the tax during the relevant period. [1] See *id.*, sched. 1, **[*1901]** §1, cl. 2(3); Brief for Respondent 7. The statute expressly set its value, and that value was the same for all companies. U.K. Windfall **[***8]** Tax Act, sched. 1, §1, cl. 2(3). The only variables that changed in the windfall tax formula for all the companies were profits (P) and flotation value (FV); the initial period (D) varied for only a few of the companies subject to the tax. The Labour government asserted that the term [365 x (P/D) x 9) represented what the flotation value *should have been* given the assumed price-to-earnings ratio of 9. Thus, it claimed (and the Commissioner here reiterates) that the tax was simply a 23 percent tax on the difference between what the companies' flotation values *should have been* and what they actually were.

B

Petitioner PPL Corporation (PPL) was an owner, through a number of subsidiaries, of 25 percent of South Western Electricity plc, 1 of 12 government-owned electric companies that were privatized in 1990 and that were subject to the tax. See *135 T.C. 304, 307, App. (2010)* (diagram of PPL corporate structure in 1997). South **[***9]** Western Electricity's total U.K. windfall tax burden was £90,419,265. In its 1997 federal income-tax return, PPL claimed a credit under *§901* for its share of the bill. The Commissioner of Internal Revenue (Commissioner) rejected the claim, but the Tax Court held that the U.K. windfall tax was creditable for U.S. tax purposes under *§901*. See *id., at 342*. The Third Circuit reversed. *665 F.3d 60, 68 (2011)*. We granted certiorari, *568 U.S. ___, 133 S. Ct. 571, 184 L. Ed. 2d 338* ***[**978]* *(2012)*, to resolve a Circuit split concerning the windfall tax's creditability under *§901*. Compare *665 F.3d, at 68*, with *Entergy Corp. & Affiliated Subsidiaries v. Commissioner, 683 F.3d 233, 239 (CA5 2012)*

II

[2] *Internal Revenue Code §901(b)(1)* provides that "[i]n the case of . . . a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued

[1] A price-to-earnings ratio "is defined as the stock price divided by annual earnings per share. It is typically calculated by dividing the current stock price by the sum of the previous four quarters of earnings." 3 New Palgrave Dictionary of Money & Finance 176 (1992).

during the taxable year to any foreign country or to any possession of the United States" shall be creditable. [2] Under relevant Treasury Regulations, [3] "[a] foreign levy is an income tax if and only if . . . [t]he predominant character of that tax is that of an income tax in the U.S. sense." *26 CFR §1.901-2(a)(1)*. The parties agree that *Treasury Regulation §1.901-2* applies **[***10]** to this case. That regulation codifies longstanding doctrine dating back to *Biddle v. Commissioner, 302 U.S. 573, 578-579, 58 S. Ct. 379, 82 L. Ed. 431 (1938)*, and provides the relevant legal standard.

The regulation establishes several principles relevant to our inquiry. First, [4] the "predominant character" of a tax, or the normal manner in which a tax applies, is controlling. See *id., at 579, 58 S. Ct. 379, 82 L. Ed. 431* ("We are here concerned only with the 'standard' or normal tax"). Under this principle, a foreign tax that operates as an income, war profits, or excess profits tax in most instances is creditable, even if it may affect a handful of taxpayers differently. Creditability is an all or nothing proposition. As the Treasury Regulations **[*1902]** confirm, [5] "a tax either is or is not an income tax, in its entirety, for all persons subject to the tax." *26 CFR §1.901-2(a)(1)*.

Second, **[***11]** [6] the way a foreign government characterizes its tax is not dispositive with respect to the U.S. creditability analysis. See *§1.901-2(a)(1)(ii)* (foreign tax creditable if predominantly "an income tax in the U.S. sense"). In *Biddle*, the Court considered the creditability of certain U.K. taxes on stock dividends under the substantively identical predecessor to *§901*. The Court recognized that "there is nothing in [the statute's] language to suggest that in allowing the credit for foreign tax payments, a shifting standard was adopted by reference to foreign characterizations and classifications of tax legislation." *302 U.S., at 578-579, 58 S. Ct. 379, 82 L. Ed. 431*. See also *United States v. Goodyear Tire & Rubber Co., 493 U.S. 132, 145, 110 S. Ct. 462, 107 L. Ed. 2d 449 (1989)* (noting in interpreting *26 U.S.C. §902* that *Biddle* is particularly applicable "where a contrary interpretation would leave" tax interpretation "to the varying tax policies of foreign tax authorities"); *Heiner v. Mellon, 304 U.S. 271, 279, 58 S. Ct. 926, 82 L. Ed. 1337, 1938-1 C.B. 319, and n. 7 (1938)* (state-law definitions generally not controlling in federal tax context). Instead of the foreign government's characterization of the tax, the crucial inquiry is the tax's economic effect. See *Biddle, supra, at 579, 58 S. Ct. 379, 82 L. Ed. 431* (inquiry **[***12]** is "whether [a tax] is the substantial equivalent of payment of the tax as those terms are used in our **[**979]** own statute"). In other words, [7] foreign tax creditability depends on whether the tax, if enacted in the U.S., would be an income, war profits, or excess profits tax.

Giving further form to these principles, [8] *Treasury Regulation §1.901-2(a)(3)(i)* explains that a foreign tax's predominant character is that of a U.S. income tax "[i]f . . . the foreign tax is likely to reach net gain in the normal circumstances in which it applies." The regulation then sets forth three tests for assessing whether a foreign tax reaches net gain. A tax does so if, "judged on the basis of its predominant character, [it] satisfies each of the realization, gross receipts, and net income requirements set forth in *paragraphs (b)(2)*, *(b)(3)* and *(b)(4)*, respectively, of this section." *§1.901-2(b)(1)*. [3] The tests indicate that net gain

[2] Prior to enactment of what is now *§901*, income earned overseas was subject to taxes not only in the foreign country but also in the United States. See *Burnet v. Chicago Portrait Co., 285 U.S. 1, 7, 52 S. Ct. 275, 76 L. Ed. 587, 1932 C.B. 286, 1932-1 C.B. 286 (1932)*. The relevant text making "income, war-profits and excess-profits taxes" creditable has not changed since 1918. See Revenue Act of 1918, §§222(a)(1), 238(a), 40 Stat. 1073, 1080.

[3] The relevant provisions provide as follows:

(also referred to as net income) consists of realized gross receipts reduced by significant costs and expenses attributable to such gross receipts. A foreign tax that reaches net income, or profits, is creditable.

III

A

It is undisputed that **[***14]** net income is a component of the U.K.'s "windfall tax" **[*1903]** formula. See Brief for Respondent 23 ("The windfall tax takes into account a company's profits during its four-year initial period"). Indeed, annual profit is a variable in the tax formula. U.K. Windfall Tax Act, sched. 1, §1, cls. 2(2) and 5. It is also undisputed that there is no meaningful difference for our purposes in the accounting principles by which the U.K. and the U.S. calculate profits. See Brief for Petitioners 47. The disagreement instead centers on how to characterize the tax formula the Labour Party adopted.

The Third Circuit, following the Commissioner's lead, believed it could look no further than the tax formula that the Parliament enacted and the way in which the Labour government characterized it. Under that view, the windfall tax must be considered a tax on the difference between a company's flotation value (the total amount investors paid for the company when the government sold it) and an imputed "profit-making value," defined as a company's "average annual profit during its 'initial period' . . . times 9, the assumed price-to-earnings ratio." *665 F.3d, at 65*. So characterized, the tax captures a portion **[***15]** of the difference between the price at which each company was sold and the price at which the Labour government believed **[**980]** each company *should have been* sold given the actual profits earned during the initial period. Relying on this characterization, the Third Circuit believed the windfall tax failed at least the Treasury Regulation's realization and gross receipts tests because it reached some artificial form of valuation instead of profits. See *id., at 67*, and n. 3.

In contrast, PPL's position is that the substance of the windfall tax is that of an income tax in the U.S. sense. While recognizing that the tax ostensibly is based on the difference between two values, it argues that every "variable" in the windfall tax formula except for profits and flotation value is fixed (at least with regard to 27 of the 32 companies). PPL emphasizes that the only way the Labour government was able to calculate the imputed "profit-making value" at which it claimed companies should have been privatized was by looking after the fact at the *actual profits* earned by each company. In PPL's view, it matters not how the U.K. chose to arrange the formula or what it *claimed* to be taxing, because a tax based **[***16]** on profits above some threshold is an excess profits tax, regardless of how it is mathematically arranged or what labels foreign law places on it. PPL, thus, contends that the windfall taxes it paid meet the Treasury Regulation's tests and are creditable under *§901*.

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[9] "A foreign tax satisfies **[***13]** the realization requirement if, judged on the basis of its predominant character, it is imposed—(A) Upon or subsequent to the occurrence of events ('realization events') that would result in the realization of income under the income tax provisions of the Internal Revenue Code." *26 CFR §1.901-2(b)(2)(i)*.

[10] "A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of—(A) Gross receipts; or (B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value." *§1.901-2(b)(3)(i)*.

[11] "A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts . . . to permit—(A) Recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or (B) Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses." *§1.901-2(b)(4)(i)*.

We agree with PPL and conclude that the predominant character of the windfall tax is that of an excess profits tax, a category of income tax in the U.S. sense. It is important to note that the Labour government's conception of "profit-making value" as a backward-looking analysis of historic profits is not a recognized valuation method; instead, it is a fictitious value calculated using an imputed price-to-earnings ratio. At trial, one of PPL's expert witnesses explained that "'9 is not an accurate P/E multiple, and it is not applied to current or expected future earnings.'" 135 T.C., at 326, n. 17 (quoting testimony). Instead, the windfall tax is a tax on realized net income disguised as a tax on the difference between two values, one of which is completely fictitious. See App. 251, Report ¶1.7 ("[T]he *value in profit making terms* described in the wording of the act . . . is not a real value: it is rather a construct based **[***17]** on realised profits that would not have been known at the date of privatisation").

The substance of the windfall tax confirms the accuracy of this observation. As already noted, the parties stipulated that **[*1904]** the windfall tax could be calculated as follows:

Tax = 23% [(365 x (P / D) x 9) - FV]

This formula can be rearranged algebraically to the following formula, which is mathematically and substantively identical: [4]

**[**981]** Tax = [365 x 9 x 23% / D] x {P - [FV x D / 365 x 9]}

The next step is to substitute the actual number of days for D. For 27 of the 32 companies subject to the windfall tax, the number of days was identical, 1,461 (or four years). Inserting that amount for D in the formula yields the following:

Tax = [365 x 9 x 23% / 1,461] x {P [FV x 1,461 / 365 x 9]}

Simplifying the formula by multiplying and dividing numbers reduces the formula to:

Tax = 51.7% x [P - (FV / 9) x 4.0027]

As noted, FV represents the value at which each company was privatized. FV is then divided by 9, the arbitrary "price-to-earnings ratio" applied to every company. The economic effect is to convert flotation value into the profits a company *should* have earned given the assumed price-to-earnings ratio. See **[***18]** 135 T.C., at 327 ("'In effect, the way the tax works is to say that the amount of profits you're allowed in any year before you're subject to tax is equal to one-ninth of the flotation price. After that, profits are deemed excess, and there is a tax'" (quoting testimony from the treasurer of South Western Electricity plc)). The annual profits are then multiplied by 4.0027, giving the total "acceptable" profits (as opposed to windfall **[*1905]** profit) that each company's flotation value entitled it to earn during the initial period given the artificial price-to-earnings ratio of 9. This fictitious amount is finally subtracted from *actual* profits, yielding the excess profits, which were taxed at an effective rate of 51.71 percent.

The rearranged tax formula demonstrates that the windfall tax is economically equivalent to the difference between the profits each company *actually* earned and the amount the Labour government believed it *should* have earned given its flotation value. For the 27 companies that had 1,461-day initial periods, the U.K. tax formula's substantive effect was to

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[4] The rearrangement requires only basic algebraic manipulation. First, because order of operations does not matter for multiplication and division, the formula is rearranged to the following:

Tax = 23% [(365 x 9 (P / D))) - FV]

Next, everything outside the brackets is multiplied by [365 x 9 / D], and everything inside the brackets is multiplied by the inverse, [D / 365 x 9]. The effect is the same as multiplication by the number one (since {[365 x 9 / D] x {[D / 365 x 9]} = 1). That **[***19]** multiplication yields the formula in the text.

impose a 51.71 percent tax on all profits earned above a threshold. That is a classic excess profits tax. See, *e.g.*, Act of Mar. 3, 1917, ch. 159, Tit. II, §201, 39 Stat. 1000 (8 percent tax imposed on excess profits exceeding the sum of $5,000 plus 8 percent of invested capital).

Of course, other algebraic reformulations of the windfall tax equation are possible. See 665 F.3d, at 66; Brief for Anne Alstott et al. as *Amici Curiae* 21-23 (Alstott Brief). The point of the reformulation is not that it yields a particular percentage (51.75 percent for most of the companies). Rather, the algebraic reformulations illustrate the economic substance of the tax and its interrelationship with net income.

The Commissioner argues that any algebraic rearrangement is improper, asserting that U.S. courts **[***20]** must take the foreign tax rate as written and accept whatever tax base the foreign tax purports to adopt. Brief for Respondent 28. As a result, the Commissioner claims that the analysis begins and ends with the Labour government's choice to characterize its tax base as the difference between "profit-making value" and flotation value. Such a rigid construction is unwarranted. It cannot be squared with the black-letter principle that [12] "tax law deals in economic realities, not legal abstractions." *Commissioner v. Southwest Exploration Co., 350 U.S. 308, 315, 76 S. Ct. 395, 100 L. Ed. 347, 134 Ct. Cl. 903, 1956-1 C.B. 614 (1956)*. Given the artificiality of the **[**982]** U.K.'s method of calculating purported "value," we follow substance over form and recognize that the windfall tax is nothing more than a tax on actual profits above a threshold.

B

We find the Commissioner's other arguments unpersuasive as well. First, the Commissioner attempts to buttress the argument that the windfall tax is a tax on value by noting that some U.S. gift and estate taxes use actual, past profits to estimate value. Brief for Respondent 17-18 (citing *26 CFR §20.2031-3 (2012)* and *26 U.S.C. §2032A*). This argument misses the point. In the case of valuation for gift and estate taxes, **[***21]** past income may be used to estimate future income streams. But, it is *future* revenue-earning potential, reduced to market value, that is subject to taxation. The windfall profits tax, by contrast, undisputedly taxed *past*, realized net income alone.

The Commissioner contends that the U.K. was not trying to establish valuation as of the 1997 date on which the windfall tax was enacted but instead was attempting to derive a proper flotation valuation as of each company's flotation date. Brief for Respondent 21. The Commissioner asserts that there was no need to estimate future income (as in the case of the gift or estate recipient) because actual revenue numbers for the privatized companies were available. *Ibid.* That argument also misses the mark. It is true, of course, that the companies might have been privatized at higher flotation values had the government recognized how efficient—and **[*1906]** thus how profitable—the companies would become. But, the windfall tax requires an underlying concept of value (based on actual *ex post* earnings) that would be alien to any valuer. Taxing actual, realized net income in hindsight is not the same as considering past income for purposes of estimating future **[***22]** earning potential.

The Commissioner's reliance on Example 3 to the Treasury Regulation's gross receipts test is also misplaced. *Id.*, at 37-38; *26 CFR §1.901-2(b)(3)(ii), Ex. 3*. That example posits a petroleum tax in which "gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted. This computation is designed to produce an amount that is greater than the fair market value of actual gross receipts." *Ibid.* Under the example, a tax based on inflated gross receipts is not creditable.

The Third Circuit believed that the same type of algebraic rearrangement used above could also be used to rearrange a tax imposed on Example 3. It hypothesized:

> "Say that the tax rate on the hypothetical extraction tax is 20%. It is true that a 20% tax on 105% of receipts is mathematically equivalent to a 21% tax on 100% of receipts, the latter of which would satisfy the gross receipts requirement. PPL proposes that we make the same move here, increasing the tax rate from 23% to 51.75% so that there is no multiple of receipts in the tax base. But if the regulation allowed us to do that, the example would be a nullity. *Any* tax on a multiple of receipts **[***23]** or profits could satisfy the gross receipts requirement, because we could reduce the starting point of its tax base to 100% of gross receipts by imagining a higher tax rate." *665 F.3d, at 67*.

**[**983]** The Commissioner reiterates the Third Circuit's argument. Brief for Respondent 37-38.

There are three basic problems with this approach. As the Fifth Circuit correctly recognized, there is a difference between imputed and actual receipts. "Example 3 hypothesizes a tax on the extraction of petroleum where the income value of the petroleum is deemed to be . . . deliberately greater than actual gross receipts." *Entergy Corp., 683 F.3d, at 238*. In contrast, the windfall tax depends on *actual* figures. *Ibid.* ("There was no need to calculate imputed gross receipts; gross receipts were actually known"). Example 3 simply addresses a different foreign taxation issue.

The argument also incorrectly equates imputed *gross receipts* under Example 3 with *net income*. See *665 F.3d, at 67* ("*[a]ny*tax on a multiple of receipts or profits"). As noted, a tax is creditable only if it applies to realized gross receipts *reduced by significant costs and expenses attributable to such gross receipts*. *26 CFR §1.901-2(b)(4)(i)*. **[***24]** A tax based solely on gross receipts (like the Third Circuit's analysis) would be noncreditable because it would fail the Treasury Regulation's *net income* requirement.

Finally, even if expenses were subtracted from imputed gross receipts before a tax was imposed, the effect of inflating only gross receipts would be to inflate revenue while holding expenses (the other component of net income) constant. A tax imposed on inflated income minus actual expenses is not the same as a tax on net income. [5]

**[*1907]** For these reasons, a tax based on imputed gross receipts is not creditable. But, as the Fifth Circuit explained in rejecting the Third Circuit's analysis, Example 3 is "facially irrelevant" to the analysis of the U.K. windfall tax, which is based on true net income. *Entergy Corp., supra, at 238*. [6]

* * *

The economic substance of the U.K. windfall

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[5] Mathematically, the Third Circuit's hypothetical was incomplete. It should have been:

20% [ 105% (Gross Receipts) - Expenses ] = Tax

But 105% of gross receipts minus expenses is *not* net income. Thus, the 20% tax is not a tax on net income and is not creditable.

[6] An *amici* brief argues that because two companies had initial periods substantially shorter than four years, the predominant character of the **[***25]** U.K. windfall tax was not a tax on income in the U.S. sense. See Alstott Brief 29 (discussing Railtrack Group plc and British Energy plc). The argument amounts to a claim that two outliers changed the predominant character of the U.K. tax. See *135 T.C. 304, 340, n. 33 (2010)* (rejecting this view).

The Commissioner admitted at oral argument that it did not preserve this argument, a fact reflected in its briefing before this Court and in the Third Circuit. See Tr. of Oral Arg. 35-36; Opening Brief for Appellant and Reply Brief for Appellant in No. 11-1069 (CA3). We therefore express no view on its merits.

tax is that of a U.S. income tax. The tax is based on net income, and the fact that the Labour government chose to characterize it as a tax on the difference between two values is not dispositive under Treasury Regulation §1.901-2. Therefore, the tax is creditable under §901.

The judgment of the Third Circuit is reversed.

*It is so ordered.*

**Concur by:** SOTOMAYOR

## Concur

**[**984]** Justice **Sotomayor**, concurring.

The Court's conclusion that the windfall tax is a creditable excess profits tax under 26 U.S.C. §901(b)(1) depends on two interrelated analytic moves: first, **[***26]** restricting the "predominant character" analysis to those companies that shared an "initial period" of rate regulation of 1,461 days; and second, treating the tax's initial period variable as fixed. See ante, at ___ - ___, 185 L. Ed. 2d, at 980-981. But there is a different way of looking at this case. If the predominant character inquiry is expanded to include the five companies that had different initial periods, especially those with much shorter initial periods, it becomes impossible to rewrite the windfall tax as an excess profits tax. Instead, it becomes clear that the windfall tax is functionally a tax on value. But because the Government took the position at oral argument that the predominant character inquiry should disregard such "outlie[r]" companies, see Tr. of Oral Arg. 38-39, and this argument is therefore only pressed by *amici*, Brief for Anne Alstott et al. as *Amici Curiae* 28-30 (hereinafter Alstott Brief), I reserve consideration of this argument for another day and another context and join the Court's opinion.

* * *

The Internal Revenue Code provides that "income, war profits, and excess profits taxes" paid to a foreign country are creditable. 26 U.S.C. §901(b)(1). Whether a foreign tax falls within **[***27]** one of these categories depends on whether its "predominant character . . . is that of an income tax in the U.S. sense." 26 CFR §1.901-2(a)(1)(ii) (2010). As the Court explains, there are three components to this inquiry, ante, at ___ - ___, 185 L. Ed. 2d, at 978-979, but at its core the inquiry simply asks whether a foreign tax resembles a typical income, war profits, or excess profits tax, ante, at ___, 185 L. Ed. 2d, at 975.

Importantly, though, the relevant Treasury Regulations also provide that a foreign tax "is or is not an income tax, in its entirety, for all persons subject to the tax." 26 CFR §1.901-2(a)(1). One way to **[*1908]** understand this language is that for a tax to be classed as a creditable income tax, its predominant character must be that of an income tax with respect to "all persons subject to the tax." Of course, among the many persons subject to a tax, some may face tax burdens different from the majority of affected taxpayers. The challenge in applying predominant character analysis will sometimes lie in determining whether and how such outlier taxpayers affect the characterization of a given tax. [1]

[1] For example, some taxes may produce outliers that might suggest that the tax is not an income tax, when in fact the tax is attempting **[***28]** to reach net gain and therefore has the predominant character of an income tax. This situation often arises when a tax relies on imperfect estimates and assumptions in attempting to calculate net gain. Such a tax strives to treat similarly situated taxpayers the same but fails to do so only because the estimated component inadvertently affects some taxpayers differently. A situation of this kind occurred in Texasgulf, Inc. v. Commissioner, 172 F.3d 209 (CA2 1999). In that case, a Canadian mining tax did not permit taxpayers to deduct their specific expenses, but did permit them to deduct a fixed "processing allowance." Id., at 211-213. The taxpayer argued that the tax was creditable because the processing allowance was an attempt to reach net income, gross income minus expenses, by using "'a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenditures.'" Id., at 215 (quoting 26 CFR §1.901-2(b)(4)(i)(B) (1999)). To support its argument, the taxpayer

**[**985]** The windfall tax at issue here exemplifies this problem. As the Court notes, *ante, at ___ - ___, 185 L. Ed. 2d, at 976-977*, the parties stipulated to the following form of the windfall tax:

*Tax* = 23% x [(365 x *P* / *D* x 9) - *FV*]

If the predominant character analysis is restricted to those 27 companies that share an identical initial period length, then it makes sense to fix D at 1,461, as the Court does. *Ante, at ___ - ___, 185 L. Ed. 2d, at 981*. And from there, it is just a matter of basic algebra, *ante, at ___ - ___, 185 L. Ed. 2d, at 980, and n. 4*, to show that these companies' tax liability is equal to total profits minus a threshold amount (in this case, 44.47% of each company's flotation **[***30]** value) multiplied by a percentage-form tax rate: *Tax* = 51.71% x [*P* - (44.47% x *FV*)]. See *ante, at ___, 185 L. Ed. 2d, at 980*; Brief for Petitioners 10. Because an excess profits tax is generally a tax levied on the profits of a business beyond a particular threshold, see Wells, Legislative History of Excess Profits Taxation in the United States in World Wars I and II, 4 Nat. Tax J. 237, 243 (1951), it appears to follow the windfall tax can properly be characterized as an excess profits tax.

But not all of the 32 affected companies had an initial period length of 1,461 days; 5 of the companies had different initial periods. See App. 34, 39-41. When these different initial period values are inserted into the formulation proposed by PPL, two results follow. First, these companies have tax rates different from the 51.71% **[*1909]** rate the Court calculates for the 27 companies. Second their excess profits threshold also varies.

For example, consider Railtrack Group, a clear outlier with an initial with an initial period of 316 days. Inserting this value onto the stipulated formula yields the following:

*Tax* = 23% x [(365 x P/316 x 9) - *FV*]

Applying the Court's algebra, this formula can be reduced to the following: *Railtrack* ***[***31] Group's Tax*** = 239.10% [*P* - (9.62% x *FV*)]. Railtrack Group's "effective" tax rate and its excess profits threshold (239.10% and 9.62% respectively) are very different from those companies with common initial period length of 1,461 days (51.71% and 44.47%). See *ante, at ___, 185 L. Ed. 2d, at 981*. Railtrack Group is not alone in this respect: four other companies also had tax rates and excess profits thresholds that differed from the majority of affected companies. See App. 34, 38-40. [2]

Once these outlier companies are included in the creditability analysis, **[**986]** **[***32]** it becomes clear that the windfall tax "is *not* an income tax . . . for all persons" subject to it. *26 CFR §1.901-2(a)(1)* (emphasis added). A typical income tax applies a fixed percentage rate to a base income that varies across taxpayers. An excess profits tax does the same, but incorporates a threshold, which may or may not vary across taxpayers, to exempt a portion

introduced empirical evidence that roughly 85% of companies facing mining tax liability had nonrecoverable expenses less than the processing allowance. *Texasgulf, Inc., 172 F.3d, at 215-216*. **[***29]** The Court of Appeals agreed with the taxpayer that the tax was a creditable income tax because it was clear that the mining tax was attempting to reach net income, albeit by using an estimate to calculate deductions. *Id., at 216-217*. This result is sensible: A company that happens to have deductible expenses greater than the fixed amount set by the processing allowance is not an instructive outlier regarding the mining taxes predominant character. The mining tax is attempting to reach that company's net income, but fails to do only because it relies on an approximate value for deductions.

[2] The figures for the other four companies are as follows: Powergen plc, which had an initial period of 1,463 days had a tax rate of 51.64% and an excess profits threshold of 44.54%, App. 38-39; National Power plc, which had an initial period of 1,456 days, had a rate of 51.89% and a treshold of 44/32%, *id.*, at 39-40; Northern Ireland Electricity plc, which had an initial period of 1,380 days, had a rate of 54.75% and a threshold of 42.01%, *id.*, at 40; and British Energy plc, which had an initial period of 260 days, had a rate of 290.60% and a threshold of 7.91%, *id.*, at 34. British Energy, however, did not end up having any windfall tax liability. *Id.*, at 33.

of the base from taxation. In contrast, here both of the rate and threshold components vary from company to company according to the D variable. [3]

Seen through this lens, the windfall tax is really a tax on average profits. See Alstott Brief 28-30. Under the **[***33]** parties' stipulated form of the windfall tax, each company pays a fixed tax rate of 23% on a base that is calculated by first multiplying a company's daily average profits during its initial period (*i.e.*, (*P/D*), or total profits over the initial period divided by the length of the initial period) by a fixed price-to-earnings ratio; and then subtracting that company's flotation value (*FV*). See *ante, at ___, 185 L. Ed. 2d, at 977*. In practice, this means that, for example, a company that earns $100 million over 1,461 days would pay approximately the same amount of taxes as a company that has earned $25 million over 365 days. These two companies would have almost the same *average* **[*1910]** profits. See Alstott Brief 28. This is not how an income tax works.

The difference between a tax on profits and tax on average profits is especially significant for properly characterizing a tax such as the windfall tax. Average daily profits multiplied by a price-to-earnings ratio, rather than being a way of approximating income, is a way of approximating value. [4] See Thompson, A Lawyer's Guide to Modern Valuation Techniques in Mergers and Acquisitions, 21 J. Corp. L. 457, 532-533 (1996) (describing similar valuation techniques using **[***34]** price-to-earnings ratios). Accordingly, incorporating an outlier like Railtrack Group into the predominant character analysis suggests that the windfall tax is a tax on a company's value. Railtrack Group and the companies like it are not random outliers, Brief for Petitioners 38, n. 3, but instead are critical pieces of data for understanding how the tax actually functioned as a matter of "economic realit[y]." *Commissioner v. Southwest Exploration Co., 350 U.S. 308, 315, 76 S. Ct. 395, 100 L. Ed. 347, 134 Ct. Cl. 903, 1956-1 C.B. 614 (1956)*.

**[**987]** This argument, however, rests on the premise that because the relevant regulations state that "a tax either is or is not an income tax, in its entirety, for all persons subject to the tax," *26 CFR §1.901-2(a)(1)(ii)*, a tax's predominant character must be **[***35]** as an income tax for *all* taxpayers. But if a tax only needs to be an income tax for "a substantial number of taxpayers" and does not have to "satisfy the predominant character test in its application to all taxpayers," *Exxon Corp. v. Commissioner, 113 T.C. 338, 352 (1999)*, then this average profits argument cannot get off the ground. Under this reading, the regulations tell courts to treat outliers like Railtrack Group as flukes.

At oral argument, the Government apparently rejected the notion that "outliers" like Railtrack Group are relevant to creditability analysis. See Tr. of Oral Arg. 35-39. The Government also did not argue these outliers' relevance before the Court of Appeals, *ante, at ___, n. 6, 185 L. Ed. 2d, at 983*, and so this argument, and the regulatory interpretation it depends upon, has

[3] At oral argument, PPL contended that an excess profits tax in which the excess profits threshold varies according to market capitalization would also have an effective tax rate that varies across taxpayers but remains creditable. Tr. of Oral Arg. 26-27. That might be true, but that does not describe the situation here. In PPL's hypothetical, any shift in the effective tax rate depends on the profits threshold; Here, under PPL's version of the windfall tax, both the effective tax rate and the profits threshold move proportionately to a company's initial period length.

[4] Petitioners suggested at oral argument that because some of the outlier taxpayers may have been subject to a more favorable regulatory regime in the wake of their privatization, their outsized tax rates are less meaningful because they could recoup their windfall tax burdens. See *id.*, at 16-17. Even accepting the premise of this argument, it still does not change that fact that in "substance," *ante, at ___, 185 L. Ed. 2d, at 980*, the tax functioned as value tax for these companies.

only been presented to this Court by *amici*, see Alstott Brief 17-18, 28-30. We are not barred from considering statutory and regulatory interpretations raised in an *amicus* brief, but we should be “reluctant to do so,” *Davis v. United States, 512 U.S. 452, 457, n. (1994, 114 S. Ct. 2350, 129 L. Ed. 2d 362)*, when the issue is one of first impression and the Federal Government has staked out what appears to be a contrary position. Thus, while I find **[***36]** this argument persuasive, I do not base my analysis of this case on it and therefore concur in the Court’s opinion.

## References

*26 U.S.C.S. § 901(b)*

2 Federal Income, Gift, and Estate Taxes § 2.06 (Matthew Bender)

L Ed Digest, Income Taxes § 145

L Ed Index, Corporate Taxes

Modern status of rule dealing with public policy as ground for denying deduction for federal income tax purposes. *16 L. Ed. 2d 1117*.

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# *Rent-A-Center, Inc. v. Hegar*

Court of Appeals of Texas, Third District, Austin

June 11, 2015, Filed

NO. 03-13-00101-CV

**Reporter**

468 S.W.3d 220; 2015 Tex. App. LEXIS 5865

Rent-A-Center, Inc., Appellant v. Glenn Hegar, in his capacity as Comptroller of Public Accounts of the State of Texas; and Ken Paxton, in his capacity as Attorney General of the State of Texas, Appellees

**Prior History: [**1]** FROM THE DISTRICT COURT OF TRAVIS COUNTY, 250TH JUDICIAL DISTRICT. NO. D-1-GN-11-001059, HONORABLE LORA J. LIVINGSTON, JUDGE PRESIDING.

**Disposition:** Reversed and Remanded.

## Case Summary

### Overview

HOLDINGS: [1]-The court erred in determining that the rent-to-own business was not entitled to a franchise-tax refund because the majority of the business's activities constituted retail trade, and since the majority of its revenues came from such activities, it was primarily engaged in retail trade as a matter of law; the business's offer of merchandise to customers under a rental-purchase agreement was more like selling than leasing.

### Outcome

Judgment reversed and case remanded.

**Counsel:** For Appellant: Mr. Farley P. Katz, Mr. Forrest Seger, II, Strasburger & Price, LLP, San Antonio, TX; Mr. Daniel L. Butcher, Mr. P. Michael Jung, Strasburger & Price, LLP, Dallas, TX.; Mr. Clinton A. Rosenthal, Mr. Robert M. O'Boyle, Strasburger & Price, LLP, Austin, TX.

For Appellee:, Mr. Matthew H. Frederick, Office of the Attorney General, Assistant Solicitor General, Mr. Jim B. Cloudt, Assistant Attorney General, Austin, TX.

**Judges:** Before Justices Puryear, Goodwin, and Field.

**Opinion by:** David Puryear

## Opinion

**[*221]** This case presents an issue of first impression: whether a "rent-to-own" business whose majority of revenues comes from making merchandise available to customers via "rental-purchase" agreements is "primarily engaged in retail trade" for Texas franchise-tax purposes.[1] The Comptroller audited Rent-A-

[1] Recent amendments to the Tax Code render this issue moot going forward. *See Tex. Tax Code § 171.0001(12)(D)* (definition of "retail trade" now specifically includes "rental-purchase agreement activities regulated by Chapter 92, Business & Commerce Code" as well **[**2]** as several other activities involving rental of items). However, the statute applicable at the time of the dispute was silent on the subject of rental-purchase agreements. *See* Act of May 2, 2006, 79th Leg., 3d C.S., ch. 1, § 2, *sec. 171.0001(12)*, 2006 Tex. Gen. Laws 1, 2 (amended 2015) (current version at *Tex. Tax Code § 171.0001(12)(D)*). We may not look to the recent legislature's amendments for insight on the intent or understanding of a previous legislature. *See Strayhorn v. Willow Creek Res., Inc., 161 S.W.3d 716, 722 (Tex. App.—Austin 2005, no pet.)*.

Center, Inc.'s franchise tax return for 2008 and assessed a deficiency of over one million dollars because it determined that Rent-A-Center was not primarily engaged in retail trade and not, therefore, entitled to the one-half-percent tax rate with which Rent-A-Center calculated its taxes. *See* Tex. Tax Code § 171.002(a), (b) (franchise tax is one percent of taxable margin except for entities "primarily engaged in retail or wholesale trade," which are subject to one-half-percent rate).

Rent-A-Center paid the deficiency under protest and filed a suit for a refund. *See id.* §§ 112.001, .051, .052. The case was tried before a jury, but the trial court dismissed the jury after determining that the only issues in dispute were legal questions for the court to decide. The trial court held that Rent-A-Center is not entitled to a refund.[2] Because we conclude that Rent-A-Center is primarily engaged in retail trade, we reverse the trial court's judgment, render judgment that Rent-A-Center is entitled to a refund based on computing its taxes with the one-half-percent tax rate, and remand this cause for a determination of the amount of refund to which Rent-A-Center is entitled.

## BACKGROUND

Rent-A-Center is the largest "rent-to-own" business in the United States, operating over 3,000 stores nationwide, in Canada, and in Puerto Rico. Through its showrooms, Rent-A-Center offers its customers merchandise in four basic product categories: furniture and accessories, major consumer electronics, appliances, and computers. All of the merchandise is available for immediate purchase from the showroom floor by payment with cash or credit card. However, the vast majority of Rent-A-Center's revenue derives from payments for merchandise made available to customers on a "rent-to-own" basis pursuant to "rental-purchase agreements." Under such an agreement, the customer **[*222]** may choose among weekly, semi-monthly, or monthly payment intervals. Payment is due at the beginning of each term, and the agreement renews **[**4]** automatically for another term upon receipt of each payment.

The agreements further provide that a customer acquires ownership of the merchandise by making all required payments over a specified period of time; the average full term for a merchandise item is eighteen months, which is substantially shorter than the useful life of the merchandise. While a customer may terminate the agreement at any time and return the merchandise without penalty—and may later "reinstate" the agreement by receiving credit for the payments already made on either the same or substantially the same merchandise—Rent-A-Center may not terminate the agreement so long as the customer fulfills its terms.

In addition to the automatic ownership transfer after the period established in the rental-purchase agreement, the agreements provide two other flexible options through which customers may sooner acquire ownership of the merchandise: (1) a "90-days same as cash" provision, by which the customer may purchase the merchandise by paying the specified "cash purchase price" within ninety days of entering into the agreement; and (2) an "early purchase option," by which the customer pays a specified percentage of the amount **[**5]** of remaining payments due at the time such option is exercised. Merchandise that has been returned to or repossessed by Rent-A-Center is refurbished and made available to customers

[2] Because of its legal determination on Rent-A-Center's entitlement to a refund, the trial court did not reach **[**3]** the second main issue at trial: the amount of deduction for the cost of goods sold that Rent-A-Center is entitled to deduct from its total revenue. *See* Tex. Tax Code §§ 171.101, .1012(c-f) (taxable margin is lesser of (1) 70% of total revenue or (2) amount of total revenue, reduced by (a) compensation paid to individuals serving active military duty and (b) *either* cost of goods sold or other compensation paid).

under similar terms as new merchandise, with a price adjustment to reflect that the merchandise is used.

Ninety-seven percent of Rent-A-Center's merchandise is sold to customers by means of showroom-floor cash purchases, "90-days same as cash," "early purchase options," or completion of all scheduled payments under rental-purchase agreements. The remaining three percent that is not sold is merchandise that is stolen, damaged, or lost through casualty. In 2007, the average time that a merchandise item spent in Rent-A-Center's system was twenty months, including time in a customer's possession while subject to a rental-purchase agreement plus any idle time in inventory, and ownership to any given item transferred to a customer after an average of three rental-purchase agreements. Also in 2007, over ninety percent of Rent-A-Center's revenues were from payments received under rental-purchase agreements.

In its original franchise tax report for 2008,[3] Rent-A-Center reported that its business activities were described **[**6]** in Division G (Retail Trade) of the Standard Industrial Classification (SIC) Manual and asserted that it was subject, therefore, to the one-half-percent tax rate applicable to entities primarily engaged in retail trade. *See* Act of May 2, 2006, 79th Leg., 3d C.S., ch. 1, § 2, *sec. 171.0001(12)*, 2006 Tex. Gen. Laws 1, 2 (amended 2015) (current version at *Tex. Tax Code § 171.0001(12)*) ("Former *Section 171.0001(12)*"); *Tex. Tax Code § 171.002(a)*, *(b)*. Rent-A-Center also claimed a deduction for its cost of goods sold in the amount of $1,200,108,807. In an audit of this report, the Comptroller determined that Rent-A-Center was a service business under Division I (Services) of the SIC Manual and that, accordingly, Rent-A-Center was not eligible for **[*223]** the one-half-percent rate but instead was subject to the one-percent tax rate for entities not primarily engaged in retail trade. *See Tex. Tax Code § 171.002(a)*, *(b)*. Additionally, the Comptroller disallowed Rent-A-Center's claimed deduction for cost of goods sold. The Comptroller issued an Adjustment Report assessing a deficiency of $1,070,683.67, plus interest. Rent-A-Center paid this amount under protest and, in this lawsuit, seeks a refund.

## DISCUSSION

The basic facts **[**7]** in this case are not in dispute, and the only issue for our review is the proper application of the franchise-tax statutes to the undisputed facts, requiring us to determine whether Rent-A-Center is "primarily engaged" in retail trade. *See id. § 171.002(c)* (taxable entity is primarily engaged in retail or wholesale trade if "total revenue from its activities in retail or wholesale trade is greater than the total revenue from its activities in trades other than the retail or wholesale trades"); Former *Section 171.0001(12)* ("retail trade" means "the activities described in Division G of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget"). Essentially, we are asked to determine whether the trial court properly concluded that Rent-A-Center's rent-to-own activities are more like leasing than selling. We conclude that they are not. Rather, we conclude that the majority of Rent-A-Center's activities constitute retail trade and—because the majority of its revenues comes from such activities—it is primarily engaged in retail trade as a matter of law.

The construction of a statute is a question of law that we review de novo. *First Am. Title Ins. Co. v. Combs, 258 S.W.3d 627, 632 (Tex.*

[3] A tax report for a given year is based on revenues and other financial data from the previous year. *See Universal Frozen Foods Co. v. Rylander, 78 S.W.3d 588, 590 (Tex. App.—Austin 2002, no pet.)*.

2008). Our primary objective in construing statutes **[**8]** is to give effect to the legislature's intent, which we seek first and foremost in the statutory text. *Id.* Absent legislative definition, we rely on the plain meaning of the text unless a different meaning is apparent from the context or application of the literal language would lead to absurd results. *City of Rockwall v. Hughes, 246 S.W.3d 621, 625-26 (Tex. 2008)*; *see* *Tex. Gov't Code § 311.011(a)* ("Words and phrases shall be read in context and construed according to the rules of grammar and common usage."). If an undefined term has multiple common meanings, we will apply the definition most consistent with the context of the statutory scheme. *State v. $1,760.00 in U.S. Currency, 406 S.W.3d 177, 180-81 (Tex. 2013)*.

The Tax Code refers to the well-known SIC Manual for descriptions of activities that fall under the umbrella of retail trade. A copy of the relevant portions of the SIC Manual was admitted into evidence. Division G of the manual, covering retail trade, provides:

> This division includes **establishments engaged in selling merchandise** for personal or household consumption and rendering services incidental to the sale of the goods. In general, retail establishments are classified by the kind of business according to the principal lines of commodities sold (groceries, hardware, etc.), or the usual trade designation (drug store, cigar store, **[**9]** etc.). Some of the important characteristics of retail trade establishments are: the establishment is usually a place of business and is engaged in activities to attract the general public to buy; the establishment buys or receives merchandise as well as sells; the establishment may process its products, but such processing is incidental or subordinate to selling; the establishment is considered as retail in the trade; and the establishment **[*224]** sells to customers for personal or household use. Not all of these characteristics need be present and some are modified by trade practice.

(Emphasis added.)

Thus, we must determine whether Rent-A-Center is "engaged in selling merchandise" as contemplated by the SIC Manual and, if so, whether the majority of its revenues comes from such activities. The following undisputed facts are relevant: (1) one hundred percent of Rent-A-Center's merchandise is offered for sale; (2) ninety-seven percent of its merchandise, for which it receives ninety percent of its revenues, is sold in an average of twenty months per item; (3) the average number of rental-purchase agreements after which any given item is ultimately sold is three; and (4) the total price that **[**10]** a customer must pay for a given item decreases from one rental-purchase agreement to the next for that same item due to the item's then being considered used. In short: ninety-seven percent of Rent-A-Center's merchandise, for which it receives ninety percent of its revenues, is sold in an average of twenty months.

Given these facts, the Comptroller's contention that Rent-A-Center is not primarily engaged in "retail trade" (i.e., selling merchandise) is strained. The Tax Code asks whether the revenues from Rent-A-Center's *activities* in retail trade exceed those from *activities* in other trades, but the Comptroller frames the question as asking whether Rent-A-Center's revenues from *sales* exceed its revenues from *leases*. The Comptroller relies almost exclusively on Rent-A-Center's SEC 10-K filing wherein it characterized its revenues from the rental-purchase agreements as "rentals and fees" and only a small minority of its revenues as "merchandise sales" as well as the fact the agreements refer to the arrangement as a "rental" agreement. The characterization in

Rent-A-Center's 10-K is neither dispositive nor, in light of all the facts, accurate.[4] *See* Destec Energy, Inc. v. Houston Lighting & Power Co., 966 S.W.2d 792, 794-95 (Tex. App.—Austin 1998, no pet.) (substance of transaction will generally **[**11]** control over its form); *see also* Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisers, LLC v. United States, 659 F.3d 466, 479 (5th Cir. 2011) (transaction's tax consequences depend on its substance rather than its form).

The Comptroller also takes issue with the use of the following terms in the rental-purchase agreements, arguing that the terms support its contention that Rent-A-Center is primarily engaged in renting: "rental," "lease," "lessor," and "lessee." However, the agreements also use terms supporting characterization of these arrangements as sales: "purchase," "consumer," "owner," and "ownership." The default occurrence, upon the customer making all specified payments under the agreement's terms, is that the customer acquires ownership of the merchandise. Rent-A-Center may not prevent the customer from acquiring ownership **[**12]** in this manner once the agreement is in place unless the customer breaches one of the agreement's provisions. And, while the Comptroller notes that title to the merchandise remains with Rent-A-Center at all times until the full purchase price has **[*225]** been paid, such fact is not inconsistent with the facts that (1) for ninety-seven percent of merchandise, title in fact *does* pass to the customer; and (2) the customer may acquire title to the merchandise *at any time* by paying the remaining cost. Undoubtedly the rental-purchase transactions are hybrids of rentals and sales. The salient question is: Are they *more* like sales or leases?

In light of the undisputed facts, we conclude that Rent-A-Center's offer of merchandise to customers under the rental-purchase agreements is more like selling than leasing and that Rent-A-Center is, therefore, primarily engaged in retail trade. We sustain Rent-A-Center's first issue and hold that the trial court erred in determining that Rent-A-Center is not entitled to a refund.

In its second issue, Rent-A-Center seeks a judgment that it is entitled to its requested cost-of-goods-sold deduction, without reduction for depreciation claimed on its federal tax return, **[**13]** as no statutes explicitly require such deduction. *See* Tex. Tax Code § 171.1012(b-f) (providing extensive lists of includable and excludable direct and indirect costs in computing cost of goods sold). However, because it concluded that Rent-A-Center was not entitled to a refund, the trial court did not reach the issue of the amount of deduction to which Rent-A-Center is entitled and whether the amount of depreciation claimed on its federal tax return should operate to reduce its franchise-tax deduction. Accordingly, we make no determination on the issue of the amount of Rent-A-Center's deduction for cost of goods sold and remand that issue to the trial court for a factual determination in the first instance.[5]

## CONCLUSION

The trial court erred in **[**14]** determining that

[4] For example, besides the 10-K, the record also contains Rent-A-Center's federal tax return for 2007 in which it identified its "business activity code" as number 453990, which is defined as "all other miscellaneous store retailers," appearing as a subcategory under the larger principal activity of "retail trade" and in which it claimed its revenues from the rental-purchase agreements on line 1 as "gross receipts or sales" rather than on line 6 as "gross rents."

[5] We also note that, despite Rent-A-Center's representations to the contrary, we cannot glean from the record any specific stipulations by the parties about the schedules that Rent-A-Center submitted as evidence of its cost of goods sold and, therefore, we are not presented with merely a question of law on the issue of cost of goods sold. *Cf.* Texas Utils. Elec. Co. v. City of Waco, 919 S.W.2d 436, 440 (Tex. App.—Waco 1995, writ denied) (when issue to be determined is question of law, appellate court may render judgment instead of remanding case for further proceedings).

Rent-A-Center is not entitled to a franchise-tax refund. Accordingly, we reverse its judgment and render judgment that Rent-A-Center is subject to the one-half-percent franchise-tax rate for tax year 2008 and is, therefore, entitled to a refund of its overpayment. We remand this cause to the trial court for a determination of the amount of refund to which Rent-A-Center is entitled.

David Puryear, Justice

Before Justices Puryear, Goodwin, and Field

Reversed and Remanded

Filed: June 11, 2015

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## *Stern v. Commissioner*

United States Board of Tax Appeals

December 19, 1928, Promulgated

Docket Nos. 5887, 5943.

**Reporter**

14 B.T.A. 838; 1928 BTA LEXIS 2906

JOSEPH STERN, PETITIONER, *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT. SAMUEL STERN, PETITIONER, *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

## Syllabus

**[**1]** 1. FAIR MARKET VALUE. - The March 1, 1913, fair market value of certain coal lands determined.

2. ACCOUNTING - PARTNERSHIP - TWO BUSINESSES. - Petitioners, as partners, owned and operated two distinct and separate businesses of different character, one retail merchandising and the other the buying and selling of lands. The books and accounts of the two businesses had for many years been kept separately, those of the mercantile business on an accrual basis and those of the land business on a cash basis. *Held,* that the two businesses being separate and distinct, the use of a different system of accounting for each was proper, as the system used reflected accurately, in each case, the income received.

**Counsel:** *S. A. Hays, Esq.,* for the petitioners.

*J. Harry Byrne, Esq.,* for the respondent.

**Opinion by:** TRUSSELL

## Opinion

**[*838]** These proceedings under Dockets 5778 and 5943 are for redetermination of deficiencies in income taxes for the calendar years 1918 and 1919 asserted by respondent against the petitioners, Joseph Stern and Samuel Stern. The deficiencies are the same amount in the case of each petitioner, $2,376.24 for 1918 and $1,572.50 for 1919, and arise from **[**2]** determinations made by respondent of their respective distributive shares of the earnings of Stern Brothers, a partnership, during those years.

Petitioners assign errors (1) in respondent's determination of a profit in the sale of certain coal lands by the partnership in 1918 and 1919 and (2) in his disallowance of deductions in the years 1917, 1918, and 1919 of the full amount of interest paid by the partnership in those years.

**[*839]** FINDINGS OF FACT.

The petitioners, during the taxable years involved herein and for approximately 39 years prior to that time, were partners under the firm name of Stern Brothers. This partnership had for many years carried on two distinct and separate businesses, one the operation of two retail stores at Parkersburg, W. Va., and Uniontown, Pa., and the other the buying and selling of coal lands. Approximately two-thirds of the assets of the partnership were invested in the coal-land business and one of the partners devoted his entire time and attention to its operation.

Between December, 1909, and March 1, 1913, the partnership, in its coal-land business, acquired seven tracts of coal land in Cumberland Township, Greene County, Pennsylvania, **[**3]** of sizes and at prices as follows:

Go to Table1

All of these tracts are approximately two and one-half miles from the Monongahela River. The whole of Cumberland Township is underlain with the Pittsburgh vein of coal. In that township, as a general rule, the coal lands with a river frontage are the more valuable; also, large tracts have a greater value per acre than small isolated tracts.

In July, 1918, the partnership sold for $575 per acre tracts Nos. 2 to 7, inclusive, total of approximately 168 acres. In 1919 the partnership sold tract No. 1, containing 10.009 shares for $600 per acre.

In determining the deficiencies here involved respondent held the March 1, 1913, value of tracts Nos. 1 to 5, inclusive, to $500be per acre and computed on that basis, a gain accruing from their sale. Tracts Nos. 6 and 7 he held to have been acquired by the partnership subsequent to March 1, 1913, and computed **[**4]** a gain on the basis of their cost.

The fair market value on March 1, 1913, of tracts Nos. 2 to 7, inclusive, sold in 1918 and tract No. 1 sold in 1919, was $525 per acre.

**[*840]** During the taxable years here involved and for many years prior to that time the partnership had consistently kept the accounts of the two businesses operated by it separately. The accounts of the mercantile business were kept on the accrual basis, as that business extended credit and had various accounts receivable and maintained inventories. The accounts of the coal land business were consistently kept on a cash basis, no entries being made except of payments actually made or received of principal or interest on purchases or sales of lands.

In each of the taxable years 1917, 1918, and 1919, the partnership actually paid interest on account of transactions of the coal-land business in the amounts of $22,933.19, $29,919.12, and $12,541.25, respectively, and in computing its net income for those years, distributable to petitioners, deducted these several amounts.

For the taxable years in question, the partnership had in its coal-land business outstanding indebtedness consisting of unpaid principal **[**5]** and interest on deferred payments for purchases of land, none of which appeared upon its books. Such indebtedness for 1917 amounted to approximately $160,000; for 1918, approximately $208,000; and for 1919, approximately $190,000.

In computing the deficiencies appealed from respondent held that the income of the partnership in its coal land business should have been determined on the accrual basis and adjusted income to the extent of disallowing as deductions certain of the interest paid in 1917, 1918, and 1919, as having accrued in prior years. Such adjustment resulted in the deficiencies appealed from and in determinations of overassessments in the cases of the two petitioners for the year 1917 of $64.04 and $139.35, respectively.

OPINION.

TRUSSELL: The first issue presented is the correctness of respondent's determination of a profit to the partnership in the sale in 1918 and 1919 of certain tracts of coal land. As to five of these tracts, indicated in the findings of fact as numbers 1 to 5, it is agreed that they were acquired by the partnership prior to March 1, 1913. As to tracts Nos. 6 and 7, respondent insists that these were acquired after that date, this fact **[**6]** being evidenced by the dates of the two deeds of record, one dated in August and the other in December, 1913.

For the purpose of determining profit or loss on the subsequent sales of these properties it seems unimportant whether or not the legal title had passed to petitioners on March 1, 1913, for on that **[*841]** date they had a definite equitable interest in the property in consequence of the execution of contracts for the purchase thereof at a fixed price and the payment of a portion of the purchase price. On that date the ripening of their interest into a fee simple merely awaited the execution of the deeds and the payment of the balance of the purchase price to be made at that time. It is clearly indicated that the parties considered the actual purchase as consummated at the time the initial payment was made. Petitioners thereafter treated the lands as already acquired and prior to the delivery of the deeds entered into contracts to sell them and paid taxes on them for the year 1913. We think these properties were "acquired before March 1, 1913," within the meaning of section 20i of the Revenue Act of 1918. Cf. **[**7]** *Appalachian Realty Co., 12 B.T.A. 52*.

On the question of the March 1, 1913, fair market value all of these seven tracts of land, the record shows that there was activity in the market for coal lands in Cumberland Township, Green County, Pennsylvania, during the latter part of the year 1912 and during the year 1913. A number of sales of such land were made at prices above those obtained for similar lands in that section in preceding years. This activity appears to have been due in a large measure to the operations of one J. V. Thompson, who was buying up many smaller tracts, combining them and selling to the large coal operators. All of the sales were not to or by Thompson, his operations having the effect of stimulating the market generally. Consideration of the testimony leaves us in no doubt that a genuine market for coal lands of the character of petitioners' and in that vicinity existed during this period with prices at a level above those prevailing before that time.

The record shows, as evidence of the market for these lands in that section, that early in 1913 J. V. Thompson sold 5,500 acres of land for an average of $784 per acre. This property adjoined **[**8]** the lands here involved but had a river frontage. Late in 1912 the Youngstown Sheet & Tube Co. purchased 4,800 acres adjoining the lands here involved for $650 per acre. This property also extended to the river. Late in 1912 a tract of 100 acres on the river was sold at $1,000 per acre. On March 8, 1913, one Laidley sold for an average price of $700 per acre a tract of 198 acres 1 1/2 miles from the river. As far back as August, 1911, Thomas Ingram sold for an average price of $636.94 a tract of 157 acres located 3 1/2 miles from the river.

It is shown that Thompson in the latter part of 1913 became insolvent and his holdings of coal lands were thrown on the market by his trustees and a considerable depression resulted which had the effect of reducing the market prices for such lands in this vicinity **[*842]** to a level below those obtaining in 1910, 1911, and 1912. This depression existed for several years.

Petitioners had bought the seven tracts here involved at various times prior to March 1, 1913. The respondent in his determination fixed a fair market value on these as of that date of $500 per acre. For the largest one of these tracts petitioners had $525 **[**9]** per acre in March, 1911. For two others they had paid $495 and $500 per acre in the latter part of 1912 and for two others $500 per acre in 1909. For one of the remaining two tracts they had paid $437 per acre in January, 1910, and in the case of the other, purchased in 1909, the price is not shown but it lay adjacent to other lands belonging to petitioners which they sold at $650 per acre in 1913.

The last mentioned tract was sold by petitioners in the year 1919 at $600 per acre. The other tracts they sold together for $575 per acre in 1918 and under the proof we can not but conclude that the fair market value on March 1, 1913, of all of the several tracts was above the average cost shown. Considering the fact that petitioners' lands involved herein have no river frontage and constituted in all only a small acreage, their fair market value on that date is not measured by the price obtained for certain large tracts as testified to in the record. We think their fair market value on March 1, 1913, was $525 per acre.

The second issue is upon the disallowance by respondent of certain deductions in the years 1917, 1918, and 1919, by the partnership of Stern Brothers and representing **[**10]** interest paid in those years on indebtedness incurred for the purchase of coal lands.

It is shown that Stern Brothers operated two separate and distinct businesses, wholly different in character, one a retail mercantile business and the other a business of buying and selling coal lands. The accounts of the two businesses were kept separate and distinct and one of the partners devoted his entire time to the coal-land business in which was invested approximately two-thirds of the partnership funds.

The mercantile business extended credit and maintained inventories and consequently kept its accounts on an accrual basis. The coal-land-business accounts were kept on a strictly cash basis, only actual payments and collections being entered and these as of the date when made or received. At no time did the books of the coal-land business show its outstanding indebtedness either as to principal or interest. This method of keeping the accounts had been regularly and consistently followed for many years.

In the taxable years here involved Stern Brothers, in the operation of its coal-land business, made interest payments amounting to $22,933.19 in 1917, $29,919.12 in 1918, and $12,541.25 **[**11]** in 1919, and **[*843]** took credit in those years for the payments made in computing its net earnings for those years distributable to petitioners.

Respondent in disallowing part of the interest paid in each of the years in question takes the position that the fact that the mercantile business operated by Stern Brothers was on an accrual basis, and necessarily kept its accounts on such basis to properly reflect income, precluded the keeping of the coal-land-business accounts on any other basis. It is insisted that, as the two businesses belonged to the same partnership, they constituted the one business of Stern Brothers, and two different systems of accounting for income could not be used.

We have held on various occasions heretofore that a business can not keep its books on a hybrid basis, partially cash and partially accrual. See *Comstock-Castle Stove Co., 4 B.T.A. 114*, and *Maine Dairy Co., 4 B.T.A. 375*. The reason for such holding was that such a method resulted in a distortion of income as not being a regular and consistent method but leaving it uncertain as to how various items might be treated, and making it difficult, if not impossible, **[**12]** to verify the correctness of the result.

However, the case before us is wholly different. Here, we have two distinct businesses of an entirely different character, owned by the same individuals but operated independently and keeping separate accounts. The basis of the conclusion reached by us in the cases cited above was the necessity to require methods of accounting which would clearly reflect income. To so construe those decisions as to lay down a hard and fast rule requiring every business owned by the same individual or the same partnership to use the same method of accounting irrespective of whether it correctly reflects income would be to defeat the object sought.

In the case before us the two businesses are distinct, separate, and of different character, and maintain separate accounts. We see no objection to the accounts of the coal-land business being kept on a cash basis if its income was thereby correctly reflected, and in determining whether or not that was the case it must be kept in mind that the accounts in question have been kept on this basis for many years and the fact that it was the regular, established, and consistently followed method, is not disputed. **[**13]** Unless it is clear that it did not accurately reflect the income received it should not be disturbed.

On this question we have considered the evidence carefully and can find no indication that the cash method was not a correct and proper one for this coal-land business. We can not assume that it was incorrect merely because some of the items of expense paid in one year are shown to have been liabilities of prior years. The character of the business as shown by the proof is such as to indicate that the method used was the proper one. The adjustment made by respondent **[*844]** by merely allocating to prior years a portion of the interest paid in the taxable years was a manifest distortion of income when we consider that there was in each of those years an average of more than $180,000 of outstanding indebtedness of the business, but carrying interest during those years, which would be later paid, for which credit, as an accrued expense, was denied by the adjustment, because such indebtedness did not appear on the books as kept on a cash basis.

The several deficiencies should be redetermined in accord with the foregoing findings of fact and opinion.

Reviewed by the Board.

**[**14]** *Judgment will be entered pursuant to Rule 50.*

**Table1 (*Return to related document text*)**

| Date acquired | Number of acres | Cost per acre less than - |
|---|---|---|
| Dec. 1, 1909 | 10,009 | $500.00 |
| Jan. 2, 1910 | 13,5106 | 437.50 |
| Mar. 3, 1911 | 54.3637 | 525.00 |
| Dec. 4, 1909 | 13,6060 | 500.00 |
| Dec. 5, 1909 | 13.6060 | 500.00 |
| Dec. 6, 1912 | 25.8620 | 500.00 |
| Dec. 7, 1912 | 47.6750 | 495.00 |

**Table1 (*Return to related document text*)**

End of Document

# USA Waste Servs. of Houston, Inc. v. Strayhorn

Court of Appeals of Texas, Third District, Austin

March 18, 2004, Filed

NO. 03-03-00515-CV

**Reporter**

150 S.W.3d 491; 2004 Tex. App. LEXIS 2427

USA Waste Services of Houston, Inc., Appellant v. Carole Keeton Strayhorn, Comptroller of Public Accounts of the State of Texas, and Greg Abbott, Attorney General of the State of Texas, Appellees

**Subsequent History:** Petition for review denied by *USA Waste Servs. of Houston v. Strayhorn, 2004 Tex. LEXIS 773 (Tex., Sept. 3, 2004)*

**Prior History:** FROM THE DISTRICT COURT OF TRAVIS COUNTY, 261ST JUDICIAL DISTRICT. NO. GN003453, HONORABLE MARGARET A. COOPER, JUDGE PRESIDING.

**Disposition:** Affirmed.

## Case Summary

### Procedural Posture

Appellant waste removal company challenged a decision of the District Court of Travis County, 261st Judicial District (Texas), which granted summary judgment in favor of appellee Comptroller of Public Accounts of Texas in connection with the company's claim that it was entitled to a refund of sales taxes paid.

### Overview

The company sought a refund of sales taxes paid on steam cleaning services that the company ordered after spilling waste on a customer's property. The company argued that it was entitled to a refund because it resold the steam cleaning services to the customer. The trial court granted the Comptroller summary judgment and the court affirmed on appeal. The facts demonstrated that the company sought a sale for resale exemption under *Tex. Tax Code Ann. § 151.302(a)* for steam cleaning that it ordered after a customer called to complain that the company had spilled waste on the customer's property and not as the basis of any bargain between the company and the customer. Thus, the court concluded that the steam cleaning was not an integral part of the waste removal service that the company provided to its customers pursuant to *Tex. Tax Code Ann. § 151.006(1)* and 34 Tex. Admin. Code *§ 3.356(a)(7) (2003)*. Instead, the company ordered the steam cleaning to keep the business of an existing customer and to make the customer whole. Thus, the company did not meet its burden of demonstrating that it was entitled to an exemption and the company was not entitled to any refund.

### Outcome

The court affirmed.

**Counsel:** For Appellant: Mr. Mark W. Eidman, Mr. Ray Langenberg, Mr. Eric Hagenswold, Scott, Douglass & McConnico, LLP, Austin, TX.

For Appellees: Mr. Scott D. Simmons, Assistant Attorney General, Austin, TX.

**Judges:** Before Chief Justice Law, Justices Patterson and Puryear.

**Opinion by:** Jan P. Patterson

## Opinion

**[*493]** In this tax protest suit, USA Waste Services of Houston, Inc. ("USA") appeals from the grant of summary judgment in favor of Carole Keeton Strayhorn, Comptroller of Public Accounts, and Greg Abbott, Attorney General of the State of Texas (collectively, "Comptroller"). [1] In one issue, USA, a waste removal company, contends that it is entitled to a sales tax refund under the sale-for-resale exemption. USA seeks a refund of sales taxes paid on steam cleaning services that USA ordered after spilling waste on customers' property. For the reasons set forth below, we affirm the judgment of the district court.

### [**2] BACKGROUND

During the tax audit period for this case, January 1, 1994 through March 31, 1997, USA entered into contracts with commercial customers to remove their waste. In the course of the waste removal, USA from time to time spilled liquid onto a customer's property, either from a trash receptacle or from a USA truck. When a customer called to complain about a spill, USA hired AA Mobile Steam Cleaning to clean up the spill. USA hired AA because it did not own steam cleaning equipment. All of the steam cleaning relevant to this case occurred on the property of USA customers.

After an audit of USA's sales tax reports for January 1, 1994 through March 31, 1997, the Comptroller assessed sales tax for USA's purchases of steam cleaning services performed on customers' property. USA paid the sales tax under protest, then filed suit in a Travis County district court. *See Tex. Tax Code Ann. § 112.052* (West 2002) (suit after payment under protest). [2] In its suit, USA claimed entitlement to a refund of $ 5,570.06 in sales taxes because it resold the steam cleaning services to its customers. *See id. §§ 151.006(1)* (West 2002) (definition of **[**3]** "sale for resale"), *.302(a)* (West 2002) (sale-for-resale exemption). Both parties filed traditional motions for summary judgment based on statutory interpretation. USA argued that it was entitled to the sale-for-resale exemption and the Comptroller argued no entitlement. After a hearing, the district court rendered final judgment, granting the Comptroller's motion for summary judgment and denying USA's motion. In one issue, USA contends that because it is entitled to the sale-for-resale exemption for the steam cleaning services, the district court erred in granting the Comptroller's motion for summary judgment and denying its own.

### STANDARD OF REVIEW

#### *Summary Judgment*

The standards for review of a traditional summary judgment are well established: **[*494]** the movant must show there is no genuine issue of material fact and that **[**4]** it is entitled to judgment as a matter of law. *See Tex. R. Civ. P. 166a(c)*; *Southwestern Elec. Power Co. v. Grant, 73 S.W.3d 211, 215, 45 Tex. Sup. Ct. J. 502 (Tex. 2002)*; *Nixon v. Mr. Prop. Mgmt. Co., 690 S.W.2d 546, 548-49, 28 Tex. Sup. Ct. J. 384 (Tex. 1985)*. Here, the parties rely on statutory provisions and administrative rules to support their entitlement to summary judgment. In general, matters of

[1] The Comptroller and the Attorney General are statutory defendants in tax protest suits. *See Tex. Tax Code Ann. § 112.151(b)* (West 2002). Because their interests do not diverge in this case, for convenience we will refer to them collectively as "Comptroller."

[2] Because there have been no material revisions to the relevant provisions of the tax code since the audit period, we will refer to the current code for convenience.

statutory construction are questions of law rather than issues of fact. *City of Garland v. Dallas Morning News, 22 S.W.3d 351, 357, 43 Tex. Sup. Ct. J. 303 (Tex. 2000)*.

Generally, a party cannot appeal the denial of a motion for summary judgment because it is an interlocutory order and thus not appealable. *See Cincinnati Life Ins. Co. v. Cates, 927 S.W.2d 623, 625, 39 Tex. Sup. Ct. J. 916 (Tex. 1996)*. However, when both parties move for summary judgment and the district court grants one motion and denies the other, the unsuccessful party may appeal both the prevailing party's motion and the denial of its own. *See Holmes v. Morales, 924 S.W.2d 920, 922, 39 Tex. Sup. Ct. J. 779 (Tex. 1996)*. We review the summary judgment evidence presented by both sides, determine all questions presented, and render such judgment **[**5]** as the trial court should have rendered. *Commissioners Court v. Agan, 940 S.W.2d 77, 81, 40 Tex. Sup. Ct. J. 355 (Tex. 1997)*. We review the district court's decision to grant summary judgment *de novo*. *Natividad v. Alexsis, Inc., 875 S.W.2d 695, 699, 37 Tex. Sup. Ct. J. 722 (Tex. 1994)*.

***Statutory Construction***

Because our analysis involves interpretation of statutory provisions and administrative rules, we employ well-settled principles of statutory construction. Statutory construction is a question of law, which we review *de novo*. *Bragg v. Edwards Aquifer Auth., 71 S.W.3d 729, 734, 45 Tex. Sup. Ct. J. 375 (Tex. 2002)*. We must ascertain and give effect to the legislature's intent for the provision we are construing. *See Fleming Foods v. Rylander, 6 S.W.3d 278, 284 (Tex. 1999)*; *Union Bankers Ins. Co. v. Shelton, 889 S.W.2d 278, 280, 37 Tex. Sup. Ct. J. 1138 (Tex. 1994)*; *Calvert v. Texas Pipe Line Co., 517 S.W.2d 777, 780, 18 Tex. Sup. Ct. J. 146 (Tex. 1974)*. The legislature's intent is determined by reading the language used in the particular statute and construing the statute in its entirety. *See In re Bay Area Citizens Against Lawsuit Abuse, 982 S.W.2d 371, 380, 42 Tex. Sup. Ct. J. 182 (Tex. 1998)*; **[**6]** *Taylor v. Firemen's & Policemen's Civil Serv. Comm'n, 616 S.W.2d 187, 190, 24 Tex. Sup. Ct. J. 421 (Tex. 1981)*. We read every word, phrase, and expression in a statute as if it were deliberately chosen, and presume the words excluded from the statute are done so purposefully. *See Gables Realty Ltd. P'ship v. Travis Cent. Appraisal Dist., 81 S.W.3d 869, 873 (Tex. App.--Austin 2002, pet. denied)*; *City of Austin v. Quick, 930 S.W.2d 678, 687 (Tex. App.--Austin 1996)* (citing *Cameron v. Terrell & Garrett, Inc., 618 S.W.2d 535, 540, 24 Tex. Sup. Ct. J. 265 (Tex. 1981))*, *aff'd*, *7 S.W.3d 109, 42 Tex. Sup. Ct. J. 1217 (Tex. 1999)*; *see also* 2A Norman J. Singer, *Sutherland Statutory Construction* § 47.25 (6th ed. 2000) (stating that there is generally an inference that omissions from a statute are intentional).

Furthermore, we give serious consideration to an agency's construction of a statute, as long as the construction is reasonable and does not contradict the plain language of the statute. *Continental Cas. Co. v. Downs, 81 S.W.3d 803, 807, 45 Tex. Sup. Ct. J. 755 (Tex. 2002)* (citing *Tarrant Appraisal Dist. v. Moore, 845 S.W.2d 820, 823, 36 Tex. Sup. Ct. J. 491 (Tex. 1993))*. We recognize **[**7]** that the legislature intends an agency created to centralize expertise in a certain regulatory area "be given a large degree of latitude in the methods it uses to accomplish its regulatory function." *Moore, 845 S.W.2d at 823*. Courts, however, "do not defer to administrative interpretation in regard to questions which do **[*495]** not lie within administrative expertise, or deal with a nontechnical question of law." *Rylander v. Fisher Controls Int'l, Inc., 45 S.W.3d 291, 302 (Tex. App.--Austin 2001, no pet.)* (quoting 2B Singer, *supra* § 49.04, at 23-24).

We construe the text of an administrative rule under the same principles as if it were a statute. *Phillips Petroleum Co. v. Texas Comm'n on Envtl. Quality, 121 S.W.3d 502, 507 (Tex. App.--Austin 2003, no pet.)* (citing *Texas Gen. Indem. Co. v. Texas Workers' Comp. Comm'n, 36 S.W.3d 635, 641 (Tex. App.--Austin 2000, no pet.))*. We bear in mind that an administrative agency has the power to interpret its own rules, and its interpretation is entitled to great weight and deference. *Id.* The agency's construction of its rule is controlling unless it is plainly erroneous or inconsistent. **[**8]** *Id.*

## ANALYSIS

USA seeks a sales tax refund under the "sale for resale" provision of the tax code. The parties agree that the steam cleaning services are taxable but disagree about whether USA is responsible for paying the taxes. "The sale for resale of a taxable item is exempt from the taxes imposed by this chapter." *Tex. Tax Code Ann. § 151.302(a)*. The purpose of the sale-for-resale exemption is to prevent double taxation. *Sharp v. Clearview Cable TV, Inc., 960 S.W.2d 424, 426 (Tex. App.--Austin 1998, pet. denied)*. "Tax exemptions are subject to strict construction since they are the antithesis of equality and uniformity." *Hilltop Village, Inc. v. Kerrville Indep. Sch. Dist., 426 S.W.2d 943, 948, 11 Tex. Sup. Ct. J. 314 (Tex. 1968)*; *see North Alamo Water Supply Corp. v. Willacy County Appraisal Dist., 804 S.W.2d 894, 899, 34 Tex. Sup. Ct. J. 352 (Tex. 1991)*; *Upjohn Co. v. Rylander, 38 S.W.3d 600, 606 (Tex. App.--Austin 2000, pet. denied)*. "An exemption cannot be raised by implication, but must affirmatively appear, and all doubts are resolved in favor of the taxing authority and against the claimant." *Bullock v. National Bancshares Corp., 584 S.W.2d 268, 272, 22 Tex. Sup. Ct. J. 447 (Tex. 1979).* **[**9]** Accordingly, the claimant has the burden of clearly demonstrating that it is entitled to the exemption. *Strayhorn v. Raytheon E-Systems, Inc., 101 S.W.3d 558, 565 (Tex. App.--Austin 2003, pet. denied)* (citing *North Alamo Water Supply, 804 S.W.2d at 899*).

A "sale for resale" is a sale of tangible personal property or a taxable service to a purchaser who acquires the property or service for the purpose of reselling it . . . in the normal course of business in the form or condition in which it is acquired or as an attachment to or integral part of other tangible personal property or taxable service.

*Tex. Tax Code Ann. § 151.006(1)*. Here, USA claims a sale-for-resale exemption of a taxable service. Specifically, the steam cleaning company provided grounds cleaning, which is a real property service under the Comptroller's rules. *34 Tex. Admin. Code § 3.356(a)(7) (2003)*. A real property service may be eligible for a sale-for-resale exemption if "the buyer intends to transfer the service as an integral part of a taxable service." *Id.* *§ 3.356(c)(2) (2003)*. A service is considered to be an **[**10]** integral part of a taxable service "if the service purchased is *essential* to the performance of the taxable service and *without which the taxable service could not be rendered*." *Id.* (emphasis added).

USA argues that the steam cleaning is essential to the performance of its contractual obligation to remove all of its customers' waste, including waste that USA spills on the ground in the process of removal. The Comptroller counters that USA does not qualify for the exemption because ordering steam cleaning to clean up a spill **[*496]** that USA causes is not essential to the performance of USA's waste removal service. It follows, the Comptroller urges, that USA is not required to hire a steam cleaner but chooses to do so to keep its customers happy after they complain about a spill. Thus, the Comptroller argues, USA's business decision does not constitute an essential part of its waste removal service.

USA relies on the summary judgment affidavit of Rosa Castro, who worked in USA's operations department during the audit period, to establish that the steam cleaning was an integral part of USA's service. Castro averred: "When USA emptied a customer's dumpsters or garbage cans, waste **[**11]** often spilled onto the property of its customers. It was practically impossible for USA to perform its waste removal services without spilling waste on its customers' property." She went on to state: "To remove the spilled waste and complete its job, USA had to steam clean the ground where the waste spilled. Since USA did not own steam cleaning equipment . . ., it hired AA to steam clean the areas."

Castro's affidavit, when read in isolation, conveys that USA ordered steam cleaning services in most instances in which it provided services or, in any event, every time that it spilled waste. However, in a response to a request for admission, USA admitted that it had a property steam cleaned only when it made a spill but denied that it ordered steam cleaning *every* time that it spilled waste. And counsel for USA stated in oral argument that in the process of USA's waste removal, waste "sometimes" fell onto the ground. Sharon Wilson, USA's safety manager, averred in an affidavit, attached to the Comptroller's motion, that USA "occasionally spills liquids" in the course of waste removal. She went on to state that if a customer complains about a spill, she orders steam cleaning. [3] **[**12]**

USA argues that steam cleaning is an integral part of its waste removal service, but USA's own admission and statement from its safety manager establish that USA did not order steam cleaning every time that a spill occurred and that spills occurred only "sometimes." USA also asserts that it is entitled to the sale-for-resale exemption because the steam cleaning induces its customers to purchase USA's services. But we find no evidence in the record supporting this assertion. Quite the opposite, one can conclude from Wilson's affidavit that USA ordered steam cleaning only after a customer complained.

USA then argues that the Comptroller's construction of the resale exemption in this case is inconsistent with its construction of the exemption in other contexts. **[**13]** Included as an appendix to USA's brief is a letter from the Comptroller to an electrical subcontractor, who had asked whether its services to a general contractor were eligible for the sale-for-resale exemption. The Comptroller's response was that "your company may accept a resale certificate from ABC Company in lieu of tax on your remodeling charges *if ABC Company rebills your services to [the] project as a part of taxable remodeling services*." [4] USA asserts that its relationship with the steam cleaner is no different. However, **[*497]** other than the conclusory assertion in Castro's affidavit that "USA resold AA's steam cleaning services to USA's customers in the same form or condition in which they were acquired," USA presented no evidence that it rebills its customers for the steam cleaning. Further, USA's waste removal contract with its customers contained no reference to steam cleaning.

**[**14]** USA additionally argues that because the Comptroller has granted sale-for-resale exemptions in instances in which the service or good involved was not essential to the overall service provided, USA is also entitled to the exemption. For example, the Comptroller allowed the exemption for shower slippers given to members of a country club and

[3] At oral argument, counsel for USA stated that Wilson's affidavit covered a larger spectrum of spills because the affidavit was prepared for the administrative hearing before the Comptroller. Nevertheless, we consider the affidavit for all purposes.

[4] *See* Tex. Comptroller of Pub. Accounts, * System No. 9008L1045B01 (Aug. 31, 1990), *available at* http://aixtcp.cpa.state.tx.us/star/openrec2.html.

balloons given to customers at a Mexican restaurant. [5] The Comptroller granted the exemption for the shower slippers because "the items are considered transferred to the care, custody, and control of the members." [6] As to the balloons, the Comptroller stated that "when dealing with restaurants . . ., our agency's policy is somewhat broader than what you would think a 'sale for resale' is." [7] It allowed the exemption if customers received the balloons as part of their meal but disallowed the exemption for balloons purchased for decoration only. [8] The circumstances of those exemptions are not analogous to USA's situation. The shower slippers fell directly within the statutory definition of resale of tangible personal property as part of a service, *see* *Tex. Tax Code Ann. § 151.302(b)* (West **[**15]** 2002); the balloons were exempt because of the Comptroller's relaxed standard for restaurants.

USA also cites exemptions for third-party converter repair service ordered by a seller of cable service and flea killers added as part of a carpet cleaning service, both of which are cited in the Comptroller's rules as examples of integral parts of the services. *See* *34 Tex. Admin. Code §§ 3.310(d)* (carpet cleaning), *.313(d)(1)* (cable converter repair) (2003). Unlike USA's waste spills, one can reasonably assume that the seller of the cable repair service did not cause the converter damage. **[**16]** As to the carpet cleaning, one can reasonably assume the customer received the flea killer as part of a package. Here, the steam cleaning occurred separately from USA's waste removal service, only after a customer complained. The steam cleaning is more analogous to a construction company paying for a plant that it accidentally backed over with one of its trucks. The replacement of the plant is not an integral part of its service but instead is intended to make the customer whole.

The facts demonstrate that USA seeks a sale-for-resale exemption for steam cleaning that it ordered after a customer called to complain that USA had spilled waste on the customer's property and not as the basis of any bargain between USA and the customer. On these facts, we conclude that the steam cleaning is not an integral part of the waste removal service that USA provides to its customers. *See* *Tex. Tax Code Ann. § 151.006(1)*; *34 Tex. Admin. Code § 3.356(c)(2)*. Instead, USA ordered the steam cleaning to keep the business of an existing customer and to make **[*498]** the customer whole. Construing the exemption against the taxpayer, as we must, *National Bancshares Corp., 584 S.W.2d at 272,* **[**17]** we conclude that USA has not met the burden of clearly demonstrating that it is entitled to the exemption. *North Alamo Water Supply, 804 S.W.2d at 899*. Therefore, USA is not entitled to a refund under the sale-for-resale exemption for sales taxes paid on the steam cleaning services. We overrule USA's issue and affirm the district court's grant of summary judgment in favor of the Comptroller and denial of USA's motion for summary judgment.

## CONCLUSION

The steam cleaning that USA ordered from a third party is a real property service under the Comptroller's rules. *34 Tex. Admin. Code § 3.356(a)(7)*. A real property service may be eligible for a sale-for-resale exemption if "the buyer intends to transfer the service as an integral part of a taxable service." *Id.* *§ 3.356(c)(2)*. Here, USA failed to demonstrate that steam cleaning ordered after USA spilled

[5] *See* Tex. Comptroller of Pub. Accounts, * System Nos. 200206156T (June 6, 2002) (balloons), 9207L1183D10 (July 17, 1992) (shower slippers), *available at* http://aixtcp.cpa.state.tx.us/star/openrec2.html.

[6] Tex. Comptroller of Pub. Accounts, * System No. 9207L1183D10.

[7] Tex. Comptroller of Pub. Accounts, * System No. 200206156T.

[8] *Id.*

waste on a customer's property is an integral part of the waste removal service that USA provides to its customers. Accordingly, we hold that USA is not entitled to a refund under the sale-for-resale exemption for sales taxes paid on the steam cleaning services. We affirm the judgment **[**18]** of the district court.

Jan P. Patterson, Justice

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**Appellate History:**Requested

**Citing Decisions:**None Applied

**Other Citing Sources:**None Applied

**Table Of Authorities:**Not Requested

***Shepard's*®:** **USA Waste Servs. of Houston, Inc. v. Strayhorn** 150 S.W.3d 491,2004 Tex. App. LEXIS 2427: (Tex. App. Austin 2004)

No negative **subsequent appellate history**

## Appellate History (2)

1. **Citation you *Shepardized*™**

**USA Waste Servs. of Houston, Inc. v. Strayhorn**, 150 S.W.3d 491, 2004 Tex. App. LEXIS 2427

**Court:** Tex. App. Austin | **Date:** 2004

### Subsequent

2. B **Petition for review denied by:**

**USA Waste Servs. of Houston v. Strayhorn**, 2004 Tex. LEXIS 773

**Court:** Tex. | **Date:** Sept. 3, 2004

# Von-Lusk v. Commissioner

United States Tax Court

February 2, 1995, Filed

Docket No. 4271-93

**Reporter**

1995 U.S. Tax Ct. LEXIS 9; 104 T.C. 207; 104 T.C. No. 8

Von-Lusk, a California Limited Partnership, the Lusk Company, Tax Matters Partner, Petitioner v. Commissioner of Internal Revenue, Respondent

**Disposition:** **[*1]** Decision will be entered under Rule 155.

## Syllabus

P is a partnership organized for the purpose of managing, holding, and developing property for investment. P acquired certain raw land (the property) which it planned to subdivide. It planned to build houses on the lots of the resulting subdivision. P deducted the costs of meeting with government officials, obtaining building permits and zoning variances, negotiating permit fees, performing engineering and feasibility studies, and drafting architectural plans as "other deductions." P also deducted property taxes in respect of the property. Sec. 263A(a) and (b)( 1), I.R.C., precludes the deduction and provides for capitalization of direct and the allocable share of indirect costs allocable to property "produced by the taxpayer". And sec. 263A(g)(1), I.R.C., states that "The term '*produce*' includes construct, build, install, manufacture, *develop*, or improve." (Emphasis added.) *Held:* The Commissioner is sustained in disallowing deductions and requiring capitalization of the foregoing costs as well as property taxes paid by P in respect of the property, notwithstanding that P did not make any physical change to the property during the **[*2]** taxable years. The foregoing costs were the initial steps ancillary to actual construction of the buildings contemplated to be built. They may properly be treated as part of the development costs. Cf. Louisiana Land & Exploration Co. v. Commissioner, 7 T.C. 507 (1946), affd. 161 F.2d 842 (5th Cir. 1947). The result is not affected by the fact that local government regulations may delay or even ultimately preclude completion of the project.

**Counsel:** Milton E. Bracken (an officer), for petitioner.

Susan C. Hergenhan and Roy Wulf, for respondent.

**Judges:** Raum

**Opinion by:** RAUM

## Opinion

**[**208]** OPINION

RAUM, *Judge:* This case involves the Commissioner's determination that certain expenses deducted in Von-Lusk's returns for 1988, 1989, and 1990, were not deductible but instead were to be capitalized under section 263A. [1]

**[*3]** Von-Lusk (also referred to as the partnership) is a California limited partnership. Petitioner, the Lusk Co., is an S corporation and was the tax matters partner of Von-Lusk for 1988, 1989, and 1990. On the date the petition was filed in this case, the principal place of business for both the partnership and the Lusk Co. was in Irvine, California.

Von-Lusk filed a U.S. Partnership Return of Income (Form 1065) for each of the calendar years 1988, 1989, and 1990. On December 14, 1992, the Commissioner issued notices of final partnership administrative adjustment (FPAA) to Von-Lusk for those years in which deductions claimed on the returns for each of the years were disallowed as follows:

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

| Partnership item | 1988 | 1989 | 1990 |
|---|---|---|---|
| Interest expense | $ 190,761 | $ 352,150 | $ 457,659 |
| Taxes | 206,377 | 229,845 | 211,903 |
| Other deductions | 110,725 | 201,443 | 187,797 |

After the initial pleadings in this Court, the Commissioner filed an amendment to answer, in which the Commissioner conceded the foregoing interest expense deductions. The adjustments in the FPAA's for taxes and other deductions remain at issue. The explanation of adjustments in the FPAA's stated that "The deduction for taxes **[*4]** is not allowed because the partnership has not established that the amounts claimed were not capital in nature." It went on to state that "The deduction for other expenses is not allowed because the partnership has not substantiated that the **[**209]** amounts claimed were ordinary and necessary expenses paid or incurred by the partnership during the taxable year in carrying on a trade or business or an activity engaged in for profit or that the amounts claimed were not capital in nature."

Von-Lusk was formed in 1966 with the stated purpose of managing, holding, and developing for investment approximately 278 acres of raw land (the property), which was contributed to the partnership by its partners in 1966. Prior to the transfer, the general and limited partners (collectively) each owned an undivided one-half interest in the property. The general partner (the Lusk Co.) and the limited partners collectively (various members of the Von der Ahe family) each own a 50-percent interest in the partnership.

The Lusk Co. is a residential and commercial real estate development company. The Lusk Co. is the general partner in more than 40 general and limited partnerships in California (the Lusk **[*5]** partnerships). The Lusk partnerships invest in and develop real estate; own and rent apartments, commercial buildings, and industrial buildings; and own and operate a livestock ranch and farm.

The Lusk Co., as general partner and managing partner of real estate development partnerships, engages the services of many contractors, lobbyists, various engineers, architects, and others to perform services for these partnerships. These independent contractors, on behalf of the Lusk partnerships, meet with government officials, obtain building permits and zoning variances, negotiate permit fees, perform engineering and feasibility studies, and draft architectural plans. The contractors bill the Lusk partnerships that benefit from their work for the cost of their services. During 1988, 1989, and 1990, Von-Lusk incurred independent contractor costs of $ 17,912, $ 62,611, and $ 88,848, respectively. Von-Lusk claimed these amounts on its returns for such years under the caption "other deductions" as consultants, advertising, insurance, market research, off-premise sales, and other costs.

Service Mortgage Co. is a California corporation and an affiliate of the Lusk Co. Service Mortgage Co. provides **[*6]** management services for the Lusk Co. and the Lusk partnerships. Service Mortgage Co. employs executives, project managers, secretaries, and accountants. These employees monitor **[**210]** the Lusk partnership projects and review and direct the work of the contractors discussed above. Service Mortgage Co. bills the cost of their employees to the Lusk partnerships that benefit from the work.

When Service Mortgage Co. bills a Lusk partnership other than a partnership engaged in property management or rental activities, the amount is charged to a "work in progress" account for that particular partnership. Service Mortgage Co. includes a markup for overhead and facilities costs in the wages charged to "work in progress" accounts. The Lusk partnerships that own and operate rental property are charged for time spent by Service Mortgage Co.'s administrative personnel. These charges are deducted by the Lusk partnerships as period costs.

During 1988, 1989, and 1990, Service Mortgage Co. billed Von-Lusk in the amounts of $ 92,813, $ 138,822, and $ 98,949, respectively. These amounts include the wages, payroll taxes, and fringe benefits of Service Mortgage Co.'s administrative personnel and **[*7]** the overhead markup described above. The overhead markup represents approximately 40 percent of the total amount billed. The wages, payroll taxes, and fringe benefits of Service Mortgage Co.'s administrative personnel represent approximately 60 percent of the total amount billed. Accordingly, during 1988, 1989, and 1990, Service Mortgage Co. billed Von-Lusk approximately $ 37,125, $ 55,529, and $ 39,580, respectively, for overhead and $ 55,688, $ 83,293, and $ 59,369, respectively, for the wages, payroll taxes, and fringe benefits of Service Mortgage Co.'s administrative personnel. Von-Lusk deducted the amounts it paid to Service Mortgage Co. during the years 1988, 1989, and 1990, on its tax returns for those years under the caption "other deductions--wages and salaries".

The "other deductions" claimed on Von-Lusk's tax returns for the years 1988, 1989, and 1990, consist of the following costs:

| Other deductions | 1988 | 1989 | 1990 |
|---|---|---|---|
| Consultants | $ 13,563 | $ 49,750 | $ 74,644 |
| Advertising | 475 | 3,875 | - 0 - |
| Insurance | 711 | 905 | 916 |
| Wages and salaries | 92,813 | 138,822 | 98,949 |
| Market research | 500 | 1,625 | 6,934 |
| Off-premise sales | 2,516 | 3,837 | 5,514 |
| Other costs | 147 | 2,619 | 840 |
| Total | 110,725 | 201,433 | 187,797 |

**[*8] [**211]** The deductions for "Advertising", "Market research", and "Off-premise sales" refer to costs incurred to advise Von-Lusk as to the appropriateness of product mix and pricing for the property. Von-Lusk did not engage in active sales efforts during 1988, 1989, and 1990. On its returns for the years 1988, 1989, and 1990, Von-Lusk deducted real property taxes incurred and paid in the amounts of $ 206,377, $ 229,845, and $ 211,303, respectively. Von-Lusk also deducted $ 600 in 1990 for a California franchise tax shown to be due on its California franchise tax return.

The property is located in San Bernardino County, California, in an area called Chino Hills. Chino Hills was incorporated on December 1, 1991. Prior to this date, development was controlled by the San Bernardino County Planning Commission and Board of Supervisors.

In August 1982, the San Bernardino County Board of Supervisors approved the Chino Hills Specific Plan, which provided for 2,779 dwelling units on the property. In 1985, Von-Lusk agreed to the inclusion of the property in Chino Hills Assessment District No. 85-1, which is a special assessment district that was formed to provide for the acquisition and **[*9]** construction of certain public improvements within the district. Without further elaboration or explanation the parties have stipulated that "This special assessment increased Von-Lusk's property taxes by over $ 200,000 per year."

In 1985, Von-Lusk submitted a preliminary development plan for the property to the San Bernardino County Board of Supervisors. In January 1986, the San Bernardino County Board of Supervisors approved the preliminary development plan for the property (also referred to as the Lusk Los Serranos property and/or Fairfield Ranch). The approved Lusk Los Serranos Preliminary Development Plan provided for 1,444 dwelling units on the property. The Chino Hills Specific Plan (referred to above) had provided for 2,779 dwelling units on the property.

**[**212]** The San Bernardino County Board of Supervisors set a development fee of $ 31,680,600 for the property. The county did not reduce the development fee when it approved the preliminary development plan. The preliminary development plan allowed 1,335 fewer units than the Chino Hills Specific Plan. On a per-unit basis, this increased the development fee from $ 11,400 per unit to $ 21,940 per unit. During 1988, 1989, **[*10]** and 1990, Von-Lusk pursued an appeal in an attempt to reduce the development fee.

In January 1986, the San Bernardino County Board of Supervisors informed Von-Lusk that it would not approve a final development plan and tract map for the property unless certain conditions were met. In 1987, in response to an application filed by Von-Lusk, the property was removed from the agricultural preserve and zoned for residential development. The rezoning was done in accordance with the Chino Hills specific plan and constituted a rezoning of the property for future use. The property was used by tenant farmers to raise grass and grains during the years 1988, 1989, and 1990.

On September 22, 1988, Von-Lusk submitted tentative tract maps to the San Bernardino County Board of Supervisors. On May 18, 1989, the county approved the tentative tract maps, subject to certain conditions. Condition No. 70 provides:

no map shall be recorded for any phase of this tract until all necessary contracts have been approved and executed for the construction of Soquel Canyon Parkway from El Prado Road/Central Avenue to its planned connection with lower Carbon Canyon Road or an alternative highway in Orange County [*11] and no building permits shall be issued until 90 days prior to the projected completion of the parkway.

During 1988, 1989, and 1990, no agreement was reached between San Bernardino County and Orange County as to the location of the Soquel Canyon Parkway connection, no funding issues for the highway were approved, and no physical activities were commenced in connection with the construction of the highway.

Condition No. 125 also imposed by the San Bernardino County Board of Supervisors as a condition for approval of the tentative tract map required Von-Lusk to design, construct, and finance a six-lane addition to Soquel Canyon [**213] Parkway from the Corona Expressway interchange east to Chino Creek, a six-lane bridge at Chino Creek, a six-lane section of Soquel Canyon Parkway from the Chino Creek Bridge east to the El Prado Road/Central Avenue intersection, and a one-half width section of Central Avenue from the Corona Expressway east to the Chino Creek.

Von-Lusk appealed condition No. 70 and several other conditions. This appeal was pending during the years 1988, 1989, and 1990. During those years Von-Lusk could not obtain building permits for the property because condition No. [*12] 70 had not been met. During the years 1988, 1989, and 1990, Von-Lusk did not make any physical improvements to the property, and the property continued to be used by tenant farmers to raise grass and grains.

The parties stipulated that on August 6, 1993, *sections 1.263A-1 through 1.263A-6, Income Tax Regs.*, were adopted, and that these regulations apply to costs incurred in taxable years beginning after December 31, 1993. Accordingly, the parties agreed that neither party would argue that the facts contained in the stipulation of facts cause *section 1.263A-2(a)(3)(ii), Income Tax Regs.*, to apply to the property.

No controversy is before us as to whether Von-Lusk was engaged in an activity for profit, or whether the expenditures at issue were properly made in pursuit of a business profit. Both parties have limited their argument to, and our opinion deals exclusively with, whether the expenditures at issue should have been capitalized under *section 263A* or were properly deducted, as claimed by petitioner.

The general rule of *section 263A* is found in *section 263A(a)*, which states:

*SEC. 263A(a)*. NONDEDUCTIBILITY OF CERTAIN DIRECT AND INDIRECT COSTS. --

> (1) IN GENERAL. --In the case [*13] of any property to which this section applies, any costs described in paragraph (2)--
>
> > (A) in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs, and
> >
> > (B) in the case of any other property, shall be capitalized.
>
> (2) ALLOCABLE COSTS. --The costs described in this paragraph with respect to any property are--
>
> > (A) the direct costs of such property, and
> >
> > (B) such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property.
>
> [**214] Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.

Subsection (b) describes the property to which *section 263A* applies. Briefly stated, *section 263A* applies to (1) property produced by the taxpayer and (2) property acquired for resale. The parties agree that the property at issue was not acquired by Von-Lusk for resale, as contemplated by the statute. Therefore, for *section 263A* to be applicable, the property must be "produced by the taxpayer."

*Section 263A(g)(1)* states that "The term 'produce' includes construct, [*14] build, install, manufacture, develop, or improve." The term "produce" is given further explanation in section 1.263A-1T(a)(5)(ii), Temporary Income Tax Regs., *52 Fed. Reg. 10061* (Mar. 30, 1987), which states that "For purposes of this section, the term 'produce' includes construct, build, install, manufacture, develop, improve, create, raise or grow."

If Von-Lusk's activities fall within the description "construct, build, install, manufacture, develop, improve, create, raise or grow", then Von-Lusk "produced" the property. If Von-Lusk "produced" the property, then *section 263A* applies. If *section 263A* applies, then the direct and a proper share of the indirect costs of the property are to be capitalized.

*Section 263A* is a relatively new addition to the Internal Revenue Code, having been added by section 803 of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2350. The statute itself does not provide a comprehensive definition of "produce". Rather, it merely lists a series of examples of activities which are included in the term "produce". *Sec. 263A(g)(1)*. The Commissioner's regulations quoted above follow this path, choosing merely to add to **[*15]** the statutory list of examples rather than setting forth a comprehensive definition.

It falls on us then to determine whether Von-Lusk's activities come within the word "produce" as used by Congress in *section 263A*. To the extent that the legislative history accompanying *section 263A* furnishes some guide as to what activities Congress meant to include within the term "produce", it may be found in the reasons behind the development of *section 263A*. As the Senate Finance Committee stated:

**[**215]** The committee believes that the present-law rules regarding the capitalization of costs incurred in producing property are deficient in two respects. First, the existing rules may allow costs that are in reality costs of *producing*, acquiring, or *carrying* property to be deducted currently, rather than capitalized into the basis of the property and recovered when the property is sold or as it is used by the taxpayer. This produces a mismatching of expenses and the related income and an unwarranted deferral of taxes. Second, different capitalization rules may apply under present law depending on the nature of the property and its intended use. These differences may create distortions **[*16]** in the allocation of economic resources and the manner in which certain economic activity is organized.

The committee believes that, in order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules should govern the capitalization of costs of producing, acquiring, and holding property, including interest expense, subject to appropriate exceptions where application of the rules might be unduly burdensome.

[S. Rept. 99-313 (1986), 1986-3 C.B. (Vol. 3) 140; emphasis added.]

For virtually identical language, see H. Rept. 99-426 (1985), 1986-3 C.B. (Vol. 2) 625; Staff of the Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, at 508-509 (J. Comm. Print 1987).

Two purposes behind the enactment of *section 263A* can be gathered from this legislative history. First, Congress expected that a single set of comprehensive rules would be applied to determine whether to capitalize costs. Second, Congress expected those rules to be applied from the acquisition of property, through the time of production, until the time of disposition. To give full effect to this **[*17]** congressional purpose a broad definition of "produce" is necessary.

We must determine whether the activities engaged in by Von-Lusk properly fit within a broad definition of "produce". Von-Lusk deducted as "other expenses", under the headings consultants, advertising, insurance, market research, offpremise sales, and other costs, amounts paid for the services of independent contractors. The functions performed by these independent contractors included meeting with government officials, obtaining building permits and zoning variances, negotiating permit fees, performing engineering and feasibility studies, and drafting architectural plans. Von-Lusk deducted under "other deductions--wages & salaries" amounts paid to Service Mortgage Co. The amounts paid Service Mortgage Co. represented compensation for services provided by Service Mortgage Co. in reviewing and directing the work of the contractors discussed above.

**[**216]** While the pursuit of building permits and zoning variances, negotiating permit fees, and similar activities may not readily spring to mind as examples of production activity, we think that upon reflection they are properly classifiable as such. Such activities are **[*18]** ancillary to actual physical work on the land and are as much a part of a development project as digging a foundation or completing a structure's frame. The project cannot move forward if these steps are not taken.

Von-Lusk took purposeful steps to begin the development of the property. Petitioner attempts to place weight on the fact that Von-Lusk was formed with the stated purpose of managing, holding, and developing the property for investment. Petitioner claims Von-Lusk's activities never went beyond managing and holding. The stipulated facts indicate otherwise. Meeting with government officials, obtaining building permits and zoning variances, negotiating permit fees, performing engineering and feasibility studies, drafting architectural plans, and appealing development conditions go beyond managing and holding. *These activities represent the first steps of development*.

Having determined that Von-Lusk's activities represented the first steps in the development of the property, it then follows that Von-Lusk produced the property, as contemplated by Congress. As such, section 263A applies to the property, and Von-Lusk must capitalize the direct and a proper share of the indirect **[*19]** costs of the property.

We note that petitioner made no argument as to whether the costs at issue represented direct or indirect costs of the property. Petitioner contended only that section 263A does not apply to the property. Although we may treat this issue as conceded, see Rule 142(a), we consider it briefly below.

Section 263A(a)(2) states that the costs described in this paragraph with respect to any property are (A) the direct costs of such property, and (B) such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property. Section 1.263A-1T(b)(2)(i), Temporary Income Tax Regs., 52 Fed. Reg. 10061-10062, states: "Direct material costs and direct labor costs must be capitalized with respect to a production or resale activity * * * 'Direct labor costs' include the cost of labor that can be identified or associated with a particular activity." The costs deducted under "other deductions" pertained to the cost of **[**217]** various professionals. As such they represent the cost of labor which can be identified or associated with a particular activity.

The fact that the services of these professionals **[*20]** were arranged by the Lusk Co. or performed by Service Mortgage Co. does not take them out from under section 263A. While they may, therefore, become indirect costs, they remain "costs that directly benefit or are incurred by reason of the performance of a production or resale activity". Sec. 1.263A-1T(b)(2)(ii), Temporary Income Tax Regs. They still must be capitalized. While only the "proper share" of the indirect costs is to be capitalized, petitioner offered no proof or argument that any of these costs did not relate to the activities that we have determined to be part of the development of the property.

The property taxes paid by Von-Lusk must also be capitalized. Taxes otherwise allowable as a deduction are specifically listed as an example of indirect costs. Sec. 263A(a)(2)(B); sec. 1.263A-1T(b)(2)(iii)(I), Temporary Income Tax Regs., 52 Fed. Reg. 10062 (Mar. 30, 1987).

Petitioner states in its brief: "With respect to the terms used to define 'produce' it would seem to be a logical conclusion that the physical appearance of raw land would be altered to some degree." Petitioner attempts to use the fact that no physical change occurred on the property **[*21]** to argue that there was no production. However, section 263A contains no requirement that there be a physical change. To read such a requirement into the statute would, in our judgment, subvert the purpose of Congress in enacting a broad set of uniform rules. In our opinion, Congress meant to include in the costs to be capitalized the preliminary, nonphysical steps of development at issue here.

Petitioner's argument is similar to one rejected by this Court in Louisiana Land & Exploration Co. v. Commissioner, 7 T.C. 507 (1946), affd. 161 F.2d 842 (5th Cir. 1947). There the taxpayer attempted to deduct amounts expended for a geophysical survey of property under lease to the taxpayer. The Commissioner argued that those amounts should be capitalized under section 24(a)(2) of the Internal Revenue Code of 1939 (the forerunner of section 263). Section 24(a)(2) prohibited the deduction of amounts paid for permanent **[**218]** improvements or betterments made to increase the value of any property or estate.

The taxpayer argued: "the geophysical survey was not an improvement or betterment of its property, because it added nothing tangible **[*22]** thereto, and that it did not and could not increase the value of the property". Louisiana Land & Exploration Co. v. Commissioner, supra at 514. The Court rejected this argument. In language especially pertinent to the present case, the Court stated:

Under these circumstances it seems abundantly clear that the survey was the first step in the over-all development for oil of these tracts of land and that the benefit derived from the expenditure was to be enjoyed by petitioner in its business during the entire useful life of the asset being developed. * * * It is well settled that development expenses such as the platting, mapping, and subdividing of a tract of land held for sale must be capitalized and treated as an adjustment of the taxpayer's basis for such property. * * *, and we are unable to perceive any significant difference between such expenses and the one involved here. [Id. at 516; citations omitted.]

The Court rejected a requirement of physical change for capitalization. The result there reached is even more strongly called for in the present case. In *Louisiana Land & Exploration Co.*, the Court dealt **[*23]** with the precursor of section 263, whereas here the controlling provisions are in section 263A. And the legislative history of section 263A discloses that Congress was concerned with broadening, not narrowing, the scope of section 263 so as to avoid a "mismatching of expenses and the related income", and sought to provide for a more accurate reflection of income. See *supra* p. 215.

Petitioner next argues that the property could not be "produced" until the "production period" began. The "production period" is defined in section 263A(f)(4)(B) as beginning on the date on which production of the property begins, and ending on the date on which the property is ready to be placed in service or is ready to be held for sale. Petitioner relies upon the following explanation of the term "production period" in I.R.S. Notice 88-99, 1988-2 C.B. 422.

For purposes of the interest capitalization rules, the production period of real property generally begins when physical activity is first performed upon the property (e.g., the grading or clearing of land, the excavation of foundations or lines for utilities, the performance of mechanical activities such as plumbing or **[*24]** electrical work upon a building that is being rehabilitated **[**219]** or improved, or any other work relating to the construction or improvement of real property). * * *

Petitioner argues that since no physical activity was performed on the property, the production period did not begin for purposes of the interest capitalization rules, and that it therefore did not "produce" the property.

While petitioner's argument does have a superficial appeal, it does not survive close scrutiny. Subsection (f) of section 263A provides special rules for the *allocation of interest* to property produced by the taxpayer. It has no effect on the costs here at issue. Indeed, the narrow scope of subsection (f) is reflected in the Commissioner's concession as to the deductibility of the interest items for each of the 3 years at issue. To read the requirements of subsection (f) as applying to all costs would change the special rule to a general rule. Put differently, if no costs were to be capitalized until the beginning of the "production period", then section 263A(f)(1)(A) would be superfluous. Such a construction "offends the well-settled rule of statutory construction that all parts of a statute, **[*25]** if at all possible, are to be given effect." Weinberger v. Hynson, Westcott & Dunning, Inc., 412 U.S. 609, 633 (1973); see also Phillips Petroleum Co. v. Commissioner, 101 T.C. 78, 97 (1993) (all parts of a statute must be read together, and each part should be given its full effect).

Petitioner next argues for a consistency requirement between section 263A and section 312(n)(1). Section 312(n)(1) requires an adjustment to the earnings and profits account for construction period carrying charges. It imposes a capitalization requirement for interest, property taxes, and similar carrying charges incurred during the construction period. The term "construction period" is given the same meaning as the term "production period" under section 263A(f)(4)(B). Sec. 312(n)(1)(C).

Because the costs at issue were not incurred during the section 263A(f)(4)(B) production period, they were not incurred during the "construction period" and are, therefore, not required to be capitalized under section 312(n)(1). Petitioner argues that, in the interest of consistency, we should not require capitalization under section 263A. We disagree.

Section **[*26]** 312(n)(1) applies to costs that are otherwise deductible. Section 312(n)(1)(B) includes construction period **[**220]** carrying charges "to the extent such interest, taxes, or charges are attributable to the construction period for such property and would be allowable as a deduction in determining taxable income under this chapter for the taxable year in which paid or incurred." If costs must be capitalized under other provisions of the Internal Revenue Code, then section 312(n)(1) is not applicable. Earnings and profits will be accurately reflected through the taxpayer's decreased deductions and increased income.

The final argument made by petitioner is that some of these costs are specifically excluded from capitalization under section 1.263A-1T(b)(2)(v)(A), Temporary Income Tax Regs., 52 Fed. Reg. 10063. The costs excluded by that regulation are marketing, selling, advertising, and distribution expenses. Petitioner uses this regulation to argue that the advertising, market research, and off premise sales expenses are not capital expenditures.

Petitioner stipulated that those expenditures "refer to costs incurred to advise Von-Lusk as to the appropriateness **[*27]** of product mix and pricing for the Property. Von-Lusk did not engage in active sales efforts during 1988, 1989 and 1990." As such, these expenses are not of the type contemplated by the above-cited regulation. The label applied by petitioner is irrelevant.

We are aware that conditions imposed on Von-Lusk by local government authorities made the delay of this project unavoidable and the continued pursuit of the project so financially unattractive as to possibly preclude going forward with it. That does not change our view that steps were taken to begin the development of the property. The result of those steps is that Von-Lusk came under the rule of *section 263A*. [2]

**[*28]** In the light of our conclusion above that the deductions in controversy must be capitalized, it is unnecessary to consider the Commissioner's alternative argument that the "other expenses", if not required to be capitalized by *section 263A*, should be capitalized under section 263.

**[**221]** Since respondent has conceded the interest deductions originally at issue,

*Decision will be entered under Rule 155*.

[2] We are aware of the opinion in *Hustead v. Commissioner*, T.C. Memo. 1994-374, which contains some dicta as to the scope of the term "produce" in respect of certain expenditures for activities that were less extensive than and were quite unlike the expenditures involved herein. The case also considered whether the property was held by the taxpayer primarily for sale to customers in the ordinary course of trade or business so as to bring sec. 263A(b)(2) into play in the circumstances there before the Court. The Court ultimately bypassed the applicability of sec. 263A, and held the expenditures nondeductible by reason of sec. 263.

**Title:** *Von-Lusk v. Commissioner, 1995 U.S. Tax Ct. LEXIS 9*

**Folder:** IRC 263A

## Notes

**Ahlrich, Danielle**

Case has a legislative history description for why IRC 263A enacted. Also finds that the TP engaged in development constituting production via early land development steps (e.g., securing permits).

Frontier opinion on this case: Our holding in Von-Lusk v. Commissioner, 104 T.C. 207 (1995), illustrates that activities in addition to physical construction may be included in the production of real property. In Von-Lusk, the question was whether a partnership had to capitalize costs such as performing engineering and feasibility studies and drafting architectural plans. We held that those activities were development activities even though they had no immediate physical impact on the property. Id. at 216. In deciding Von-Lusk, we reviewed the text and legislative history of section 263A and observed that Congress intended the term "produce" to be broadly construed.

May 25, 2016 10:41:11 am

# Zimmer US, Inc. v. Combs

Court of Appeals of Texas, Third District, Austin

February 9, 2012, Filed

NO. 03-11-00178-CV

**Reporter**
368 S.W.3d 579; 2012 Tex. App. LEXIS 1109; 2012 WL 413995

Zimmer US, Inc., Appellant v. Susan Combs, Comptroller of Public Accounts of the State of Texas; and Greg Abbott, Attorney General of the State of Texas, Appellees

**Prior History:** **[**1]** FROM THE DISTRICT COURT OF TRAVIS COUNTY, 345TH JUDICIAL DISTRICT. NO. D-1-GN-09-002096, HONORABLE STEPHEN YELENOSKY, JUDGE PRESIDING.

**Disposition:** Reversed and Rendered.

## LexisNexis® Headnotes

Civil Procedure > Appeals > Summary Judgment Review > Standards of Review

***HN1*** Summary judgments are reviewed de novo.

Civil Procedure > Appeals > Summary Judgment Review > Standards of Review

***HN2*** When both parties move for summary judgment on the same issues and the trial court grants one motion and denies the other, the appellate court considers the summary-judgment evidence presented by both sides, determines all questions presented, and if it finds the trial court erred, renders the judgment the trial court should have rendered.

Administrative Law > Judicial Review > Standards of Review > De Novo Standard of Review

Administrative Law > Judicial Review > Standards of Review > Rule Interpretation

Civil Procedure > Appeals > Standards of Review > De Novo Review

Governments > Legislation > Interpretation

***HN3*** The construction of a statute and administrative rule are legal questions the appellate court reviews de novo.

Governments > Legislation > Interpretation

***HN4*** When resolving an issue of statutory construction, the court must first and foremost follow the plain language of the statute. Where statutory language is ambiguous, its construction by an agency charged with its enforcement is entitled to serious consideration so long as it is reasonable and does not contradict the statute's plain language.

Administrative Law > Judicial Review > Standards of Review > Rule Interpretation

Governments > Legislation > Interpretation

***HN5*** Deference is owed to an agency regulation interpreting a statute only when the statute is ambiguous and the agency's construction is reasonable.

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

***HN6*** Statutory exemptions from taxation are strictly construed against the taxpayer.

Administrative Law > Judicial Review > Standards of Review > Rule Interpretation

***HN7*** Administrative rules are ordinarily construed in the same manner as statutes. Unless a rule is ambiguous, the court follows the rule's clear language; when there is vagueness, ambiguity, or room for policy determinations in a rule, the court defers to the agency's interpretation unless it is plainly inconsistent with the language of the rule.

Tax Law > State & Local Taxes > Use Taxes > General Overview

***HN8*** The use tax, imposed on the consumption of goods purchased out of state and brought into Texas, is designed to more evenly distribute the tax burden among all consumers by imposing a tax on the fruits of an interstate purchase as well as on the sale of property in the State. The tax serves to prevent avoidance of a state's sales tax by the purchase of goods in another state, and to place retailers in the state upon equal footing with out-of-state competitors, who are not obligated to collect and remit sales tax.

Tax Law > State & Local Taxes > Use Taxes > Imposition of Tax

***HN9*** Tex. Tax Code Ann. § 151.313(a)(5) (2008) exempts from the use tax a brace; hearing aid or audio loop; orthopedic, dental, or prosthetic device; ileostomy, colostomy, or ileal bladder appliance; or supplies or replacement parts for the listed items. Tex. Tax Code Ann. § 151.313(a)(5). Charged under Tex. Tax Code Ann. § 111.002 with adopting rules for the enforcement of the code, the Texas Comptroller of Public Accounts has interpreted this exemption in 34 Tex. Admin. Code § 3.284 (2011).

Tax Law > State & Local Taxes > Use Taxes > Imposition of Tax

***HN10*** 34 Tex. Admin. Code § 3.284(a)(1), (12), (13) (2011).

Administrative Law > Judicial Review > Standards of Review > Arbitrary & Capricious Standard of Review

Administrative Law > Judicial Review > Standards of Review > Rule Interpretation

***HN11*** The court cannot defer to an administrative interpretation that is plainly erroneous or inconsistent with the regulation. If the agency does not follow the clear, unambiguous language of its own regulation, the court reverses its action as arbitrary and capricious.

Administrative Law > Judicial Review > Standards of Review > Rule Interpretation

Governments > Legislation > Interpretation

***HN12*** Before courts give deference to a regulation, statutory language must be ambiguous and the agency's construction must be reasonable.

Governments > Legislation > Interpretation

***HN13*** The court's first duty is to follow the plain language of the statute. If the court finds the language to be ambiguous, the court must give serious consideration to the agency's construction if it is reasonable and does not conflict with that language.

Tax Law > State & Local Taxes > Use Taxes > Imposition of Tax

***HN14*** The plain language of Tex. Tax Code Ann. § 151.313(a)(5) (2008) includes a brace; hearing aid or audio loop; orthopedic, dental, or prosthetic device; ileostomy, colostomy, or ileal bladder appliance; or supplies or replacement parts for the listed items, without defining any of those terms. The statute is therefore ambiguous to the extent that it leaves undefined terms that may be needed for the Texas Comptroller of Public Accounts' administration of the statute. By adopting 34 Tex. Admin. Code § 3.284(a)(12) (2011), the Comptroller has administratively defined the statutory term "orthopedic device" to mean any appliance or device designed specifically for use in the correction or prevention of human deformities, defects, or chronic diseases of the skeleton, joints, or spine. There is nothing in the Texas Tax Code that suggests this definition is unreasonable. 34 Tex. Admin. Code § 3.284 is a reasonable interpretation that does not contradict the Tax Code's plain language.

Administrative Law > Judicial Review > Standards of Review > Arbitrary & Capricious Standard of Review

Administrative Law > Judicial Review > Standards of Review > Rule Interpretation

Tax Law > State & Local Taxes > Use Taxes > Imposition of Tax

***HN15*** Because the interpretation of "orthopedic device" in 34 Tex. Admin. Code § 3.284 (2011) is reasonable, the Texas Comptroller of Public Accounts is obliged to follow that interpretation. If an agency does not follow the unambiguous language of its own rules, the court must consider its actions arbitrary and capricious. Valid agency rules have the same force and effect as statutes.

Administrative Law > Judicial Review > Standards of Review > Rule Interpretation

Tax Law > State & Local Taxes > Use Taxes > Imposition of Tax

***HN16*** 34 Tex. Admin. Code § 3.284 (2011) is not ambiguous. Rule 3.284 leaves no major terms undefined, and it includes very specific lists such as human deformities, defects, or chronic diseases of the skeleton, joints, or spine. The inclusion of the phrase "artificial and replaces a missing part of the body, performs the function of a vital organ or appendage of the human body, or is permanently implanted in the body" in only the definition of "prosthetic device" makes clear that those requirements are not meant to apply to "orthopedic appliances." Every word excluded from a statute must be presumed to have been excluded for a purpose. Only when it is necessary to give effect to the clear legislative intent can the court insert additional words or requirements into a statutory provision. Agency rules generally construed in same manner as statutes. Rule 3.284 is unambiguous. Unless a rule is ambiguous, the court follows the rule's clear language. The court defers to an agency's interpretation of its own rule when the rule is vague or ambiguous, unless the administrative interpretation is 'plainly erroneous or inconsistent with the regulation.

Civil Procedure > Judgments > Summary Judgment > Evidentiary Considerations

***HN17*** Evidence is conclusive when reasonable people could not differ in their conclusions.

**Counsel:** For appellant: Mr. John K. Hicks, Scott, Douglass & McConnico, LLP, Austin, TX.

For appellee: Mr. Ronald M. Johnson, Assistant Attorney General, Financial and Tax Litigation Division, Austin, TX.

For appellant: Mr. Ray Langenberg, Scott, Douglass & McConnico, LLP, Austin, TX.

**Judges:** Before Chief Justice Jones, Justices Pemberton and Henson; Concurring Opinion by Justice Pemberton.

**Opinion by:** Diane M. Henson

# Opinion

**[*581]** In this suit for a refund of use taxes paid on out-of-state purchases of certain surgical instruments, appellant Zimmer US, Inc. appeals from the trial court's order denying its motion for summary judgment and granting summary judgment in favor of appellees, Susan Combs, Comptroller of Public Accounts, and Greg Abbott, Attorney General of the State of Texas (collectively, "the Comptroller"). *See* Tex. Tax Code Ann. § 112.151 (West 2008); *see also id*. § 112.154 (West 2008). Zimmer asserts that the instruments are orthopedic devices or, alternatively, supplies for orthopedic devices and are therefore exempt from use tax under section 151.313(a)(5) of the Texas Tax Code **[**2]** and section 3.284(a) of the Texas Administrative Code ("rule 3.284"). *See* Tex. Tax Code Ann. § 151.313(a)(5) (West 2008); 34 Tex. Admin. Code § 3.284(a)(1) (2011) (Tex. Comptroller of Pub. Accounts, Drugs, Medicines, Medical Equipment, & Devices (Tax Code § 151.313)). Because **[*582]** we have determined that the instruments are exempt under section 151.313(a)(5) and rule 3.284(a), we reverse the trial court's judgment and render summary judgment in favor of Zimmer.

**BACKGROUND**

Zimmer markets and sells reconstructive implants to hospitals and healthcare providers in Texas.[1] Zimmer also develops techniques for surgical procedures to implant these prosthetics. From its parent company outside Texas, Zimmer purchases surgical instruments and lends them to healthcare providers for use in each procedure. It is these instruments that are the subject of the present tax-refund dispute. According to Zimmer, the instruments are specially designed by product engineers within its parent company for use in each of Zimmer's different surgical procedures. Zimmer asserts that the instruments at issue do not include tools for general surgical or orthopedic purposes. Rather, they are specialized and intended for **[**3]** use in specific orthopedic surgical procedures. For example, the instruments include cutting guides that ensure proper cuts to bone surfaces, "reamers" that prepare bones to accept prostheses, and "provisional" instruments that serve as trial implants by replicating aspects of the eventual prostheses.

After Zimmer learned that the Comptroller considered these instruments taxable, it made a payment to the Comptroller representing the use taxes on the instruments provided in Texas between July 2003 and February 2007. Zimmer then submitted a refund claim to the Comptroller for the portion of the tax that was not barred by limitations, a total of $947,827, plus interest. Specifically, Zimmer claimed that the instruments are exempt from taxation. After holding an administrative hearing on the matter, the Comptroller denied Zimmer's claim. *See* Tex. Tax Code Ann. § 111.105 (West 2008) (providing for administrative hearings on tax refund claims). Zimmer then sued the Comptroller for the refund in district court. After the **[**4]** parties filed cross motions for summary judgment, the trial court granted summary judgment in favor of the Comptroller. In this appeal,

[1] It is undisputed that these items are prosthetic devices exempt from the use tax. Also undisputed is the amount of tax Zimmer paid on the instruments at issue in this case.

Zimmer claims that the instruments are exempt from taxation under section 151.313(a)(5) and rule 3.284(a) as either "orthopedic devices" or, alternatively, "supplies . . . for the listed items."

## STANDARD OF REVIEW

***HN1*** Summary judgments are reviewed de novo. *Valence Operating Co. v. Dorsett*, 164 S.W.3d 656, 661 (Tex. 2005). ***HN2*** When, as here, both parties move for summary judgment on the same issues and the trial court grants one motion and denies the other, the appellate court considers the summary-judgment evidence presented by both sides, determines all questions presented, and if it finds the trial court erred, renders the judgment the trial court should have rendered. *Id*.

***HN3*** Zimmer's arguments are based primarily on the construction of the tax code and the Comptroller's rules, which are legal questions we review de novo. *7-Eleven, Inc. v. Combs*, 311 S.W.3d 676, 683 (Tex. App.—Austin 2010, pet. denied). ***HN4*** When resolving an issue of statutory construction, we must first and foremost follow the plain language of the statute. *GMC v. Bray*, 243 S.W.3d 678, 685 (Tex. App.—Austin 2007, no pet.). **[**5]** Where statutory language is ambiguous, its construction by an agency charged with **[*583]** its enforcement is entitled to serious consideration so long as it is reasonable and does not contradict the statute's plain language. *See Fiess v. State Farm Lloyds*, 202 S.W.3d 744, 747 (Tex. 2006) (explaining that ***HN5*** deference is owed to agency regulation interpreting statute only when statute is ambiguous and agency's construction reasonable); *Tarrant Appraisal Dist. v. Moore*, 845 S.W.2d 820, 823 (Tex. 1993). In addition, ***HN6*** statutory exemptions from taxation are strictly construed against the taxpayer. *North Alamo Water Supply Corp. v. Willacy County Appraisal Dist*., 804 S.W.2d 894, 899 (Tex. 1991); *DuPont Photomasks, Inc. v. Strayhorn*, 219 S.W.3d 414, 421 (Tex. App.—Austin 2006, pet. denied).

***HN7*** Administrative rules are ordinarily construed in the same manner as statutes. *Rodriguez v. Service Lloyds Ins. Co*., 997 S.W.2d 248, 254 (Tex. 1999); *7-Eleven*, 311 S.W.3d at 683. Unless a rule is ambiguous, we follow the rule's clear language; when there is vagueness, ambiguity, or room for policy determinations in a rule, we defer to the agency's interpretation unless it is plainly inconsistent with the language of **[**6]** the rule. *BFI Waste Sys. of N. Am., Inc. v. Martinez Envtl. Group*, 93 S.W.3d 570, 575 (Tex. App.—Austin 2002, pet. denied).

## DISCUSSION

***HN8*** The use tax, imposed on the consumption of goods purchased out of state and brought into Texas, is designed "to more evenly distribute the tax burden among all consumers by imposing a tax on the fruits of an interstate purchase as well as on the sale of property in the State." *Bullock v. Lone Star Gas Co*., 567 S.W.2d 493, 497 (Tex. 1978). The tax serves "to prevent avoidance of a state's sales tax by the purchase of goods in another state, and to place retailers in the state upon equal footing with out-of-state competitors, who are not obligated to collect and remit sales tax." *Bullock v. Foley Bros. Dry Goods Corp*., 802 S.W.2d 835, 838 (Tex. App.—Austin 1990, writ denied).

***HN9*** Texas Tax Code section 151.313(a)(5) exempts from the use tax "a brace; hearing aid or audio loop; orthopedic, dental, or prosthetic device; ileostomy, colostomy, or ileal bladder appliance; or supplies or replacement parts for the listed items." Tex. Tax Code Ann. § 151.313(a)(5). Charged under section 111.002 of the tax code with adopting rules for the enforcement of the code, the **[**7]** Comptroller has interpreted this exemption in rule 3.284. Subsection (a) of that rule defines various terms from the tax code as follows:

> ***HN10*** Appliance or device—An instrument, apparatus, implement, machine, contrivance, implant, chemical, or other similar or related product that does not achieve its primary intended purposes through chemical action within or on the body, and that is not dependent upon being metabolized for the achievement of its primary intended purposes.
>
> . . .
>
> Orthopedic appliance—Any appliance or device designed specifically for use in the correction or prevention of human deformities, defects, or chronic diseases of the skeleton, joints, or spine.
>
> . . .
>
> Prosthetic device—An item that is artificial and replaces a missing part of the body, performs the function of a vital organ or appendage of the human body, or is permanently implanted in the body. Examples of prosthetic devices are heart-lung pumps, nasal gastric and gastrointestinal devices, ureteral stents, urethral stents, and artificial kidney machines, and related components and supplies.

**[*584]** 34 Tex. Admin. Code § 3.284(a)(1), (12), (13) (2011).

The sole issue in the present case is whether, in light of this rule, the instruments **[**8]** Zimmer loans to healthcare providers are subject to the exemption in section 151.313(a)(5) of the tax code. Zimmer claims that the instruments are exempt for two alternate reasons: first, because they are orthopedic devices as the Comptroller has defined that term in rule 3.284, or second, because they are "related components and supplies" for Zimmer's undisputedly exempt prosthetics.[2] Accordingly, Zimmer asks that we reverse the trial court's order denying its motion for summary judgment and granting the Comptroller's.

We first turn to whether the instruments at issue are exempt as orthopedic devices. Zimmer argues that the instruments are exempt under the plain, unambiguous language of rule 3.284(a)(12), which defines "orthopedic appliance." Zimmer states that the instruments are "designed specifically for use in" orthopedic surgeries, which are a part of "the correction or prevention of human deformities, defects, or chronic diseases of the skeleton, joints, or spine." *Id*. Zimmer argues that the instruments are designed specifically for use in particular orthopedic surgical procedures, and because the implantation of prosthetics would be impossible without these procedures, they are part of the "correction" of orthopedic conditions.

Zimmer also argues that the language of rule 3.284(a)(13), defining "prosthetic device," supports its argument. In the rule, the Comptroller expressly defines a "prosthetic device" to be "an item that is artificial and replaces a missing part of the body, performs the function of a vital organ or appendage of the human body, or is permanently implanted in the body." Zimmer notes that the Comptroller **[**10]** could have included such additional requirements in the definition of "orthopedic appliance" in rule 3.284(a)(12), but did not do so. According to Zimmer, that omission should be considered intentional, and this Court should not second-guess it by reading into "orthopedic appliance" any requirements expressly stated only as to "prosthetic device." *See* Smith v. Baldwin, 611 S.W.2d 611, 616 (Tex. 1980) ("When the Legislature has carefully employed a term in one section of a statute, and has excluded it in another, it should not be implied where excluded."); *Lewis v. Jacksonville Bldg. & Loan Ass'n*, 540 S.W.2d 307, 310 (Tex. 1976) (agency rules generally construed in same manner as statutes).

The Comptroller, however, claims that the instruments are not exempt and that the court therefore correctly granted summary judgment in its favor for three reasons. First, the Comptroller argues that the instruments would only be subject to the exemption if they were implanted into the body and supported, corrected, or replaced parts of the body on an ongoing basis, which they do not. These traits are required under section 151.313(a)(5), the **[*585]** Comptroller claims, because they are common to all of the **[**11]** items listed—braces, hearing aids, colostomies, and so forth—and must therefore be read into all of the rules interpreting that section.

Second, the Comptroller notes that this requirement is reflected in years of letter rulings issued to taxpayers. For example, the Comptroller has ruled that bone wire is exempt when it is implanted in the body and non-exempt when it is not. *See, e.g.*, Tex. Comptroller of Pub. Accounts, STAR Document No. 200201747L (issued Jan. 29, 2002); Tex. Comptroller of Pub. Accounts, STAR Document No. 200508245L (issued Sept. 8, 2005). Similarly, the Comptroller has ruled that coronary stents are exempt, while coronary guide wires, catheters, and catheter supplies used during surgery are not. *See* Tex. Comptroller of Pub. Accounts, STAR Document No. 9710965L (issued Oct. 15, 1997); *see also* Tex. Comptroller of Pub. Accounts, STAR Document No. 9008L1038B01 (issued Aug. 24, 1990); Tex. Comptroller of Pub. Accounts, STAR Document No. 9510L1378D11 (issued Oct. 31, 1995) (ruling that kidney dialysis machines are exempt, while accessories for dialysis such as reclining chairs and scales are not). The Comptroller urges that such a longstanding interpretation warrants **[**12]** deferential treatment by

[2] Section 151.313(a)(5) uses only the language "orthopedic . . . or prosthetic devices" in regard to the exemption at issue in this case, while the defined terms in rule 3.284(a)(12) and (13) are "orthopedic appliance" and "prosthetic device" respectively. However, the words "device" and "appliance" are defined together in rule 3.284(a)(1), and the Comptroller acknowledges that she uses these words interchangeably. For clarity, unless specifically referring to the content of rule 3.284(a)(12), we will use the statutory language of "orthopedic device." *See* Tex. Tax Code Ann. § 151.313(a)(5) (West 2008); 34 Tex. Admin. Code § 3.284(a)(1) (2011) (Tex. Comptroller of Pub. **[**9]** Accounts, Drugs, Medicines, Medical Equipment, & Devices (Tax Code § 151.313)).

this Court. *See USA Waste Servs. of Houston, Inc. v. Strayhorn*, 150 S.W.3d 491, 495 (Tex. App.—Austin 2004, pet. denied) ("We bear in mind that an administrative agency has the power to interpret its own rules, and its interpretation is entitled to great weight and deference.").

Third, the Comptroller claims that its reading of the exemption comports with the plain language of the rule's definition of "appliance or device." The Comptroller reasons that under this definition, a qualifying item would have to "take effect as a result of, or be affected by, the actions of the human body," which items used exclusively during surgery do not do.

Zimmer contends that we must not defer to the Comptroller's interpretation of rule 3.284(a). Unless a rule is ambiguous, Zimmer stresses, we must follow the plain language of that rule. *See BFI Waste Sys. of N. Am., Inc.*, 93 S.W.3d at 575-76. Zimmer alleges that the interpretation urged by the Comptroller is inconsistent with the plain language of rule 3.284 and therefore, by giving it deference, we would sanction the Comptroller's attempt to amend its rulemaking without adhering to the Texas Administrative Procedure Act (APA). **[**13]** *See* Tex. Gov't Code Ann. §§ 2001.001-.041 (West 2008); *Myers v. State*, 169 S.W.3d 731, 734 (Tex. App.—Austin 2005, no pet.) ("Allowing an agency to create broad amendments to its rules through adjudication, rather than through its rule making authority, effectively undercuts the Administrative Procedures Act.").

We agree that the Comptroller's interpretation of rule 3.284 must be rejected if it contradicts the plain language of a rule that reasonably interprets the tax code. *See Rodriguez*, 997 S.W.2d at 254-55 (***HN11*** "[W]e cannot defer to an administrative interpretation that is 'plainly erroneous or inconsistent with the regulation' . . . . If the [agency] does not follow the clear, unambiguous language of its own regulation, we reverse its action as arbitrary and capricious."). To determine if this is the case, we first determine whether rule 3.284 reasonably interprets section 151.313 of the tax code. *See Fiess*, 202 S.W.3d at 747 (***HN12*** before courts give deference to regulation, statutory language "must be ambiguous" and "agency's construction must be reasonable"). ***HN13*** Our first duty is to follow the plain language of the statute. *General Motors Corp.*, 243 S.W.3d at 685. If we find the language **[**14]** to **[*586]** be ambiguous, however, we must give serious consideration to the agency's construction if it is reasonable and does not conflict with that language. *Railroad Comm'n v. Texas Citizens for a Safe Future & Clean Water*, 336 S.W.3d 619, 624 (Tex. 2011).

In this case, ***HN14*** the plain language of the statute includes "a brace; hearing aid or audio loop; orthopedic, dental, or prosthetic device; ileostomy, colostomy, or ileal bladder appliance; or supplies or replacement parts for the listed items," without defining any of those terms. The statute is therefore ambiguous to the extent that it leaves undefined terms that may be needed for the Comptroller's administration of the statute. *See generally Office of Pub. Util. Counsel v. Public Util. Comm'n*, 131 S.W.3d 314, 321 (Tex. App.—Austin 2004, pet. denied) ("[T]he legislature does not need to include every specific detail or anticipate all unforeseen circumstances."). By adopting rule 3.284(a)(12), the Comptroller has administratively defined the statutory term "orthopedic device" to mean "any appliance or device designed specifically for use in the correction or prevention of human deformities, defects, or chronic diseases of the skeleton, joints, **[**15]** or spine." There is nothing in the tax code that suggests this definition is unreasonable, nor does the Comptroller argue that it is. Accordingly, we hold that rule 3.284 is a reasonable interpretation that does not contradict the tax code's plain language.

***HN15*** Because the interpretation of "orthopedic device" in rule 3.284 is reasonable, the Comptroller is obliged to follow that interpretation. *Myers*, 169 S.W.3d at 734 ("If an agency does not follow the unambiguous language of its own rules, we must consider its actions arbitrary and capricious."); *BFI Waste Sys. of N. Am., Inc.*, 93 S.W.3d at 575 ("Valid agency rules have the same force and effect as statutes."). We must therefore determine whether the requirements now urged by the Comptroller—that exempt items must be implanted or continually used to support or replace a body part—are consistent with the rule. Specifically, we examine (1) whether rule 3.284 is ambiguous, and (2) if so, whether the interpretation now urged by the Comptroller contradicts the plain language of that rule. *BFI Waste Sys. of N. Am., Inc.*, 93 S.W.3d at 575-76. We hold that the ***HN16*** rule is not ambiguous, but even if it were, the Comptroller's position that "an orthopedic **[**16]** appliance or device must perform some function in the actual ongoing correction or prevention of human deformities" would contradict its plain language.

The rule at issue leaves no major terms undefined, and it includes very specific lists such as "human deformities, defects, or chronic diseases of the skeleton, joints, or spine." The inclusion of the phrase "artificial and replaces a missing part of the body, performs the function of a vital organ or appendage of the human body, or is permanently implanted in the body" in only the definition of "prosthetic device" makes clear that those requirements were not meant to apply to "orthopedic appliances." *See Cameron v. Terrell & Garrett, Inc*., 618 S.W.2d 535, 540 (Tex. 1981) ("[E]very word excluded from a statute must . . . be presumed to have been excluded for a purpose. Only when it is necessary to give effect to the clear legislative intent can we insert additional words or requirements into a statutory provision."); *Lewis*, 540 S.W.2d at 310 (agency rules generally construed in same manner as statutes). Rule 3.284 is therefore unambiguous, and we do not defer to the Comptroller's interpretation but instead follow the plain language **[**17]** of the rule. *See 7-Eleven*, 311 S.W.3d at 683 ("'Unless the rule is ambiguous, we follow the rule's **[*587]** clear language.' We defer to an agency's interpretation of its own rule when the rule is vague or ambiguous, unless the administrative interpretation is 'plainly erroneous or inconsistent with the regulation.'" (quoting *Rodriguez*, 997 S.W.2d at 254-55)); *see also Myers*, 169 S.W.3d at 734-35.

In any event, the Comptroller's interpretation is contradictory to the plain language of the rule for three reasons. First, it tries to import into "orthopedic appliance" almost precisely the same language that the Comptroller expressly used only for "prosthetic device." Second, it tacks on the requirement that a "correction" of an orthopedic condition be "continual" or "ongoing" when there is no language in the rule to suggest this is the case. Third, although the interpretation is reflected in rulings that the Comptroller has issued to taxpayers over many years, these rulings do not bind us to accept an erroneous interpretation simply because it is longstanding. *See Myers*, 169 S.W.3d at 734. Consequently, we disregard the Comptroller's interpretation and consider whether Zimmer's instruments are **[**18]** exempt under the plain language of rule 3.284.

In order to receive summary judgment, Zimmer was required to prove that there was no genuine issue of material fact concerning its instruments and that it was entitled to a judgment that they are exempt as a matter of law. *See* Tex. R. Civ. P. 166a(c). Zimmer presented undisputed summary-judgment evidence that the instruments at issue are "designed specifically for use in the correction or prevention of human deformities, defects, or chronic diseases of the skeleton, joints, or spine," including the affidavit of Kevin Cook, a director and former development engineer with Zimmer's parent company. Based on his personal knowledge of the design of Zimmer's instruments, Cook stated that each one is designed by product-development engineers to facilitate a specific step in a specific procedure to implant one of Zimmer's prostheses. Cook also described in detail the step-by-step performance of one of Zimmer's surgical techniques, emphasizing the specialized role of each instrument used in that technique to correct a defective knee joint. Attached as exhibits were video excerpts from two corrective surgeries using Zimmer's instruments, diagrams **[**19]** of Zimmer's instrument kits, and copies of pamphlets instructing healthcare providers in the execution of Zimmer's techniques using its instruments. In the affidavit, Cook explained that these demonstrated the specialized purpose of each instrument and the fact that the surgeries are part of the correction of defective joints.

The Comptroller does not dispute any material fact in Zimmer's motion for summary judgment.[3] Nor does the Comptroller dispute that the instruments are exempt under the reading of the statute urged by Zimmer. Because Zimmer's summary-judgment evidence is uncontroverted and conclusively demonstrates that the instruments satisfy the definition of "orthopedic device" under tax code section 151.313(a)(5) and rule 3.284(a)(12), we hold that Zimmer is entitled to summary judgment. *See City of Keller v. Wilson*, 168 S.W.3d 802, 806 (Tex. 2005) (noting that ***HN17*** **[*588]** evidence is conclusive when reasonable people could not differ in their conclusions).

The instruments at issue are exempt from use tax under the plain language of rule 3.284(a)(12), as it interprets tax code section 151.313(a)(5). Consequently, the trial court erred in granting the Comptroller's motion for summary judgment and denying Zimmer's.

**CONCLUSION**

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3 The Comptroller cites conflicting evidence as to whether Zimmer's prosthetic devices might be successfully implanted without the use of the instruments at issue. However, there is no indication that an item "designed specifically for **[**20]** use" in corrective procedures, as required by rule 3.284, must be strictly necessary for such procedures. This discrepancy therefore raises no "genuine issue as to any *material* fact." Tex. R. Civ. P. 166a(c) (emphasis added).

We reverse the trial court's order and render summary judgment in favor of Zimmer.

Diane M. Henson, Justice

Before Chief Justice Jones, Justices Pemberton and Henson; Concurring Opinion by Justice Pemberton

Reversed and Rendered

Filed: February 9, 2012

**Concur by:** Bob Pemberton

## Concur

**CONCURRING OPINION**

I concur in the majority's judgment. I agree that the district court's judgment must be reversed because it is predicated upon an administrative construction of rule 3.284 that is inconsistent with the rule's text. *See* 34 Tex. Admin. Code § 3.284 (2011) (Tex. Comptroller of Pub. Accounts, Drugs Medicines, Medical Equipment, and Devices (Tax Code § 151.313)); *Texas Indus. Energy Consumers v. Center Point Energy Houston Elec., LLC*, 324 S.W.3d 95, 97-100 (Tex. 2010) **[**21]** (stating that "if an agency 'does not follow the clear, unambiguous language of its own regulation, we reverse its action as arbitrary and capricious'" (quoting *Rodriguez v. Service Lloyds Ins. Co.*, 997 S.W.2d 248, 255 (Tex. 1999))). However, I do not join in the majority's sua sponte analysis of rule 3.284's validity, including its holding that the underlying statute is ambiguous.

Bob Pemberton, Justice

Before Chief Justice Jones, Justices Pemberton and Henson

Filed: February 9, 2012

*Shepard's*®: Report Content

**Appellate History:**Requested

**Citing Decisions:**None Applied

**Other Citing Sources:**None Applied

**Table Of Authorities:**Not Requested

***Shepard's*®:** **Zimmer US, Inc. v. Combs** 368 S.W.3d 579,2012 Tex. App. LEXIS 1109,2012 WL 413995: (Tex. App. Austin 2012)

No subsequent appellate history

## Appellate History (1)

1. **Citation you *Shepardized*™**

   **Zimmer US, Inc. v. Combs**, 368 S.W.3d 579, 2012 Tex. App. LEXIS 1109

   **Court:** Tex. App. Austin | **Date:** 2012

## Citing Decisions (3)

**Analysis:**Followed by (1), "Cited by" (2)

**Headnotes:**HN14 (2), HN13 (1), HN3 (1), HN4 (1), HN7 (1)

### Texas Court of Appeals

1. **Employees Ret. Sys. of Tex. v. Garcia**, 454 S.W.3d 121, 2014 Tex. App. LEXIS 13502

   LB **Cited by:** 454 S.W.3d 121 p.134

   ... ("If there is vagueness, ambiguity, or room for policy determinations in a statute or regulation, . . . we normally defer to the agency's interpretation unless it is plainly erroneous or inconsistent with the language of the statute, regulation, or rule."). Such deference is particularly appropriate where the statutes and rules at issue concern a matter within the core expertise of the agency. 41 See **Zimmer US, Inc. v. Combs , 368 S.W.3d 579 , 586 (Tex. App.—Austin 2012, no pet.)** (deferring ...

   **Discussion:** | **Court:** Tex. App. Austin | **Date:** 2014 | **Headnotes**: HN3, HN4, HN7, HN13, HN14

2. **AEP Tex. Commer. & Indus. Retail, Ltd. P'ship v. PUC of Tex.**, 436 S.W.3d 890, 2014 Tex. App. LEXIS 7711

   LB **Cited by:** 436 S.W.3d 890 p.906

   ... there is vagueness, ambiguity, or room for policy determinations in a statute or regulation, . . . we normally defer to the agency's interpretation unless it is plainly erroneous or inconsistent with the language of the statute, regulation, or rule."). Such deference is particularly appropriate where the statutes and rules at issue concern a matter within the specialized or technical expertise of the agency. 73 See **Zimmer US, Inc. v. Combs , 368 S.W.3d 579 , 586 (Tex. App.—Austin 2012, no pet.)** ...

   **Discussion:** | **Court:** Tex. App. Austin | **Date:** 2014 | **Headnotes**: HN14

3. **Winnebago Indus. v. Tex. DMV**, 2014 Tex. App. LEXIS 3836

   G **Followed by:**

   ... . Therefore, the appellate court cannot conclude that prior inspections by a manufacturer constitute "a showing of good cause" as required by the Rule. former § 215.206(9) . (every word excluded presumed excluded for a purpose); **Zimmer US, Inc. v. Combs , 368 S.W.3d 579 , 586 (Tex. App.—Austin 2012, no pet.)** (same). Instead, the Rule provided that the complainant will be required to bring the vehicle unless otherwise ordered by the ALJ upon a showing of good cause even though the statutory ...

   **Discussion:** | **Court:** Tex. App. Austin | **Date:** Apr. 10, 2014

## Other Citing Sources: (12)

### Annotated Statutes

1. **Tex. Tax Code sec. 151.313**

... presented undisputed summary judgment evidence that the instruments at issue were designed specifically for use in the correction or prevention of human deformities, defects, or chronic diseases of the skeleton, joints, or spine, and the Texas Comptroller of Public Accounts did not dispute that the instruments were exempt under the reading of the statute urged by the company. **Zimmer Us, Inc. v. Combs, 368 S.W.3d 579 , — S.W.3d —, 2012 Tex. App. LEXIS 1109 (Tex. App. Austin 2012, no pet. h.)** ...

**Content:** Statutes

### Law Reviews and Periodicals

2. **ARTICLE: Taxation**, 66 SMU L. Rev. 1181

... I. SALES TAX: STUDIES IN STATUTORY CONSTRUCTION Scope of Taxation, Exemptions, Comptroller Interpretations, Legislation Several reported cases illustrate the comptroller's efforts to broaden the scope of the sales and use tax including by narrowly interpreting exemptions to the tax. In Zimmer US, Inc. v. Combs, 2 **Zimmer US, Inc. v. Combs, 368 S.W.3d 579** (Tex. App. - Austin 2012, no pet.). the taxpayer successfully argued that some of its out-of-state purchases of surgical instruments from ...

**Content:** Law Reviews

3. **EXECUTIVE BOARD NOTE: ADMINISTRATIVE CASE LAW UPDATE**, 14 Tex. Tech Admin. L. J. 1

... denial of Appellants' motion to dismiss, the court held that chapter 150 requires a professional affiant to address nothing more than the operative facts that are the focus of the statute. The court held that it could not "conclude that the Legislature intended to require affiants with expertise in fields as engineering or architecture to opine regarding such far-afield subjects as contract construction or agency." **Zimmer US, Inc. v. Combs, 368 S.W.3d 579** (Tex. App.-Austin Feb. 9, 2012, no pet.) ...

**Content:** Law Reviews | **Date:** 2012

### Treatise Citations

4. **1-1 Texas Administrative Practice and Procedure @ 1.2**

... (Tex. App. Austin 2014) ; Southwest Pharm. Solutions, Inc. v. Tex. HHS Comm’n , 408 S.W.3d 549 , 557–58 (Tex. App.—Austin 2013) ; Tex. Bd. of Chiropractic Examiners v. Tex. Med. Ass’n , 375 S.W.3d 464 , 474–75 (Tex. App. Austin 2012) ; **Zimmer US, Inc. v. Combs , 368 S.W.3d 579 , 587 (Tex. App.—Austin 2012)** ; Nucor Steel— Tex. v. PUC , 363 S.W.3d 871 , 878–79 (Tex. App. Austin 2012) ; Liberty Mut. Ins. Co. v. Adcock , 353 S.W.3d 246 , 249 (Tex. App. Fort Worth 2011) ; PUC v. ...

**Content:** Treatises

5. **1-4 Texas Administrative Practice and Procedure @ 4.8**

**Content:** Treatises

6. **1-9 Texas Administrative Practice and Procedure @ 9.3**

... , 632 (Tex. 2008) ; P.U.C. of Texas v. Gulf States Utilities Co., 809 S.W.2d 201 , 207 (Tex. 1991) ; Tex. Bd. of Chiropractic Examiners v. Tex. Med. Ass'n , 375 S.W.3d 464 , 475 (Tex. App. Austin 2012) ; **Zimmer US, Inc. v. Combs , 368 S.W.3d 579 , 583 (Tex. App. Austin 2012)** ; PUC v. Constellation Energy Commodities Group, LLC , 351 S.W.3d 588 , 595 (Tex. App. Austin 2011) ; Scally v. Tex. State Bd. of Med. Examiners , 351 S.W.3d 434 , 441 (Tex. App. Austin 2011) ; Combs ...

**Content:** Treatises

## Briefs

7. **Southwest Royalties, Inc., Petitioner, v. Glenn Hegar, Comptroller of Public Accounts of the State of Texas, and Ken Paxton, Attorney General of the State of Texas, Respondents.**, 2014 TX S. Ct. Briefs 20364, 2015 TX S. Ct. Briefs LEXIS 536

... The Comptroller cites not one bit of authority for his nonsensical proposition that past legislative intent can be shown through the more recent acts of a head of agency. And, frankly, courts are free to find that the Comptroller is "consistently" wrong. 24 See, e.g., **Zimmer US, Inc. v. Combs, 368 S.W.3d 579 , 587** (Tex. App.-Austin 2012, no pet.) ("[A]lthough the interpretation is reflected in rulings that the Comptroller has issued to taxpayers over many years, these rulings do not bind ...

**Content:** Court Documents | **Date:** Dec. 30, 2015

8. **VERIZON BUSINESS NETWORK SERVICES, INC., Petitioner, v. SUSAN COMBS, COMPTROLLER OF PUBLIC ACCOUNTS, AND GREG ABBOTT, ATTORNEY GENERAL, Respondents.**, 2013 TX S. Ct. Briefs 343, 2013 TX S. Ct. Briefs LEXIS 1207

... Amarillo court's failure to follow the plain meaning of the term "improvements" warrants review. Rule 3.308(b)(3)'s maintenance definition is binding and this Court should look no further than the plain meaning of that definition. **Zimmer US, Inc. v. Combs, 368 S.W.3d 579 , 585-86** (Tex. App.-Austin 2012, no pet.). There is no ambiguity regarding the simple and broad term "improvements." Accordingly, this Court need not rely upon Comptroller Decisions interpreting Rule 3.308(b)(3). "[A] precondition ...

**Content:** Court Documents | **Date:** Dec. 17, 2013

9. **Texas Health and Human Services Commission, AND Office of Inspector General, Appellants, v. Antoine Dental Center, Appellee.**, 2015 TX App. Ct. Briefs 50006, 2015 TX App. Ct. Briefs LEXIS 1710

... consideration" inquiry, we will generally uphold an agency's interpretation of a statute it is charged by the Legislature with enforcing, "'so long as the construction is reasonable and does not contradict the plain language of the statute.'" Id. (citations omitted). Deference to the agency's interpretation is particularly important where, as here, the policies, rules and statutes in question concern a matter within the core expertise of the agency. See **Zimmer US, Inc. v. Combs, 368 S.W.3d 579 , 586** ...

**Content:** Court Documents | **Date:** Nov. 10, 2015

10. **SEJOON KIM, D.D.S., Appellant v. TEXAS STATE BOARD OF DENTAL EXAMINERS, Appellee**, 2013 TX App. Ct. Briefs 499, 2013 TX App. Ct. Briefs LEXIS 1880

... (Tex. App.-Austin 2002, rev. denied). The interpretation of the disciplinary matrix at issue in this case does not require any technical expertise and is, therefore, subject to de novo review by this Court. Likewise, the Board's interpretation is not given any weight when the rule at issue is unambiguous. **Zimmer US, Inc. v. Combs, 368 S.W.3d 579 , 586-87** ( Tex. App.-Austin 2012, no writ). The matrix is unambiguous in its statement that standard of care violations are handled under page 4. ...

**Content:** Court Documents | **Date:** Oct. 3, 2013

11. **Cirrus Exploration Co. v. Combs**, 2013 TX App. Ct. Briefs 36, 2013 TX App. Ct. Briefs LEXIS 245

    ... ("Statutory exemptions from taxation are subject to strict construction since they are the antithesis of equality and uniformity and because they place a greater burden on other taxpaying businesses and individuals."). When a term in a statute is undefined, the Comptroller may define the terms as needed for the Comptroller's administration of the statute, so long as it definition is reasonable. **Zimmer US, Inc. v. Combs 368 S.W.3d 579 , 586** (Tex. App.-Austin 2012, no pet.). When both sides ...

    **Content:** Court Documents | **Date:** Apr. 4, 2013

12. **DALLAS CITY LIMITS PROP. CO., L.P. v. CRADY**, 2012 TX App. Ct. Briefs 530, 2013 TX App. Ct. Briefs LEXIS 1432

    ... , and section 3.021(b) authorizes the TxRC to adopt rules and regulations for licensing in order to "safeguard the interests of the general public" in races that do not involve pari-mutuel wagering. Tex. Rev. Civ. Stat. Ann. art. 179e, § 3.021(a)-(b) (West 2010). The plain language of these provisions requires that all aspects of horse racing in Texas will be regulated by the TxRC. **Zimmer US, Inc. v. Combs, 368 S.W.3d 579 , 582** (Tex. App.-Austin 2012, no pet.), citing Gen. Motors Corp. ...

    **Content:** Court Documents | **Date:** Mar. 28, 2013

## Legend

| | | | |
|---|---|---|---|
| | Warning - Negative Treatment is Indicated | R | Red - Warning Level Phrase |
| Q | Questioned - Validity questioned by citing references | O | Orange - Questioned Level Phrase |
| | Caution - Possible negative treatment | Y | Yellow - Caution Level Phrase |
| | Positive - Positive treatment is indicated | G | Green - Positive Level Phrase |
| A | Analysis - Citing Refs. With Analysis Available | B | Blue - Neutral Level Phrase |
| I | Cited - Citation information available | LB | Light Blue - No Analysis Phrase |
| ! | Warning - Negative case treatment is indicated for statute | | |

End of Document

# 26 CFR 1.263A-1

This document is current through the August 15, 2016 issue of the Federal Register

***Code of Federal Regulations > TITLE 26 -- INTERNAL REVENUE > CHAPTER I -- INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY > SUBCHAPTER A -- INCOME TAX > PART 1 -- INCOME TAXES > NORMAL TAXES AND SURTAXES > COMPUTATION OF TAXABLE INCOME > ITEMS NOT DEDUCTIBLE***

## § 1.263A-1 Uniform capitalization of costs.

**(a)**Introduction --

**(1)**In general. The regulations under §§ 1.263A-1 through 1.263A-6 provide guidance to taxpayers that are required to capitalize certain costs under section 263A [26 USCS § 263A]. These regulations generally apply to all costs required to be capitalized under section 263A [26 USCS § 263A] except for interest that must be capitalized under section 263A(f) [26 USCS § 263A(f)] and the regulations thereunder. Statutory or regulatory exceptions may provide that section 263A [26 USCS § 263A] does not apply to certain activities or costs; however, those activities or costs may nevertheless be subject to capitalization requirements under other provisions of the Internal Revenue Code and regulations.

**(2)**Effective dates.

**(i)**In general, this section and §§ 1.263A-2 and 1.263A-3 apply to costs incurred in taxable years beginning after December 31, 1993. In the case of property that is inventory in the hands of the taxpayer, however, these sections are effective for taxable years beginning after December 31, 1993. Changes in methods of accounting necessary as a result of the rules in this section and §§ 1.263A-2 and 1.263A-3 must be made under terms and conditions prescribed by the Commissioner. Under these terms and conditions, the principles of § 1.263A-7 must be applied in revaluing inventory property.

**(ii)**For taxable years beginning before January 1, 1994, taxpayers must take reasonable positions on their federal income tax returns when applying section 263A [26 USCS § 263A]. For purposes of this paragraph (a)(2)(iii), a reasonable position is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A [26 USCS § 263A] applicable in taxable years beginning before January 1, 1994. See § 601.601(d)(2)(ii)(b) of this chapter.

**(3)**General scope --

**(i)**Property to which section 263A [26 USCS § 263A] applies. Taxpayers subject to section 263A [26 USCS § 263A] must capitalize all direct costs and certain indirect costs properly allocable to --

**(A)**Real property and tangible personal property produced by the taxpayer; and

**(B)**Real property and personal property described in section 1221(1) [26 USCS § 1221(1)], which is acquired by the taxpayer for resale.

**(ii)**Property produced. Taxpayers that produce real property and tangible personal property (producers) must capitalize all the direct costs of producing the property and the property's properly allocable share of indirect costs (described in paragraphs (e)(2)(i) and (3) of this section), regardless of whether the property is sold or used in the taxpayer's trade or business. See § 1.263A-2 for rules relating to producers.

**(iii)**Property acquired for resale. Retailers, wholesalers, and other taxpayers that acquire property described in section 1221(1) [26 USCS § 1221(1)] for resale (resellers) must capitalize the direct costs of acquiring the property and the property's properly allocable share of indirect costs (described in paragraphs (e)(2)(ii) and (3) of this section). See § 1.263A-3 for rules relating to resellers. See also section 263A(b)(2)(B) [26 USCS § 263A(b)(2)(B)], which excepts from section 263A [26 USCS § 263A] personal property acquired for resale by a small reseller.

**(iv)**Inventories valued at market. Section 263A [26 USCS § 263A] does not apply to inventories valued at market under either the market method or the lower of cost or market method if the market valuation used by the taxpayer generally equals the property's fair market value. For purposes of this paragraph (a)(3)(iv), the term fair market value means the price at which the taxpayer sells its inventory to its customers (e.g., as in the market value definition provided in § 1.471-4(b)) less, if applicable, the direct cost of disposing of the inventory. However, section 263A [26 USCS § 263A] does apply in determining the market value of any inventory for which market is determined with reference to replacement cost or reproduction cost. See §§ 1.471-4 and 1.471-5.

**(v)**Property produced in a farming business. Section 263A [26 USCS § 263A] generally requires taxpayers engaged in a farming business to capitalize certain costs. See sections 263A(d) and 263A(e) [26 USCS §§ 263A(d) and 263A(e)] and § 1.263A-4 for rules relating to taxpayers engaged in a farming business.

**(vi)**Creative property. Section 263A [26 USCS § 263A] generally requires taxpayers engaged in the production and resale of creative property to capitalize certain costs.

**(vii)**Property produced or property acquired for resale by foreign persons. Section 263A [26 USCS § 263A] generally applies to foreign persons.

**(b)**Exceptions --

**(1)**Small resellers. See section 263A(b)(2)(B) [26 USCS § 263A(b)(2)(B)] for the $ 10,000,000 gross receipts exception for small resellers of personal property. See § 1.263A-3(b) for rules relating to this exception. See also the exception for small resellers with de minimis production activities in § 1.263A-3(a)(2)(ii) and the exception for small resellers that have property produced under contract in § 1.263A-3(a)(3).

**(2)**Long-term contracts. Except for certain home construction contracts described in section 460(e)(1) [26 USCS § 460(e)(1)], section 263A [26 USCS § 263A] does not apply to any property produced by the taxpayer pursuant to a long-term contract as defined in section 460(f) [26 USCS § 460(f)], regardless of whether the taxpayer uses an inventory method to account for such production.

**(3)**Costs incurred in certain farming businesses. See section 263A(d) [26 USCS § 263A(d)] for an exception for costs paid or incurred in certain farming businesses. See § 1.263A-4 for specific rules relating to taxpayers engaged in the trade or business of farming.

**(4)**Costs incurred in raising, harvesting, or growing timber. See section 263A(c)(5) [26 USCS § 263A(c)(5)] for an exception for costs paid or incurred in raising, harvesting, or growing timber and certain ornamental trees. See § 1.263A-4, however, for rules relating to taxpayers producing certain trees to which section 263A [26 USCS § 263A] applies.

**(5)**Qualified creative expenses. See section 263A(h) [26 USCS § 263A(h)] for an exception for qualified creative expenses paid or incurred by certain free-lance authors, photographers, and artists.

**(6)**Certain not-for-profit activities. See section 263A(c)(1) [26 USCS § 263A(c)(1)] for an exception for property produced by a taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit. This exception does not apply, however, to property produced by an exempt organization in connection with its unrelated trade or business activities.

**(7)**Intangible drilling and development costs. See section 263A(c)(3) [26 USCS § 263A(c)(3)] for an exception for intangible drilling and development costs. Additionally, section 263A [26 USCS § 263A] does not apply to any amount allowable as a deduction under section 59(e) [26 USCS § 59(e)] with respect to qualified expenditures under sections 263(c), 616(a), or 617(a) [26 USCS §§ 263(c), 616(a), or 617(a)].

**(8)**Natural gas acquired for resale. Under this paragraph (b)(8), section 263A [26 USCS § 263A] does not apply to any costs incurred by a taxpayer relating to natural gas acquired for resale to the extent such costs would otherwise be allocable to cushion gas.

**(i)**Cushion gas. Cushion gas is the portion of gas stored in an underground storage facility or reservoir that is required to maintain the level of pressure necessary for operation of the facility. However, section 263A [26 USCS § 263A] applies to costs incurred by a taxpayer relating to natural gas acquired for resale to the extent such costs are properly allocable to emergency gas.

**(ii)**Emergency gas. Emergency gas is natural gas stored in an underground storage facility or reservoir for use during periods of unusually heavy customer demand.

**(9)**Research and experimental expenditures. See section 263A(c)(2) [26 USCS § 263A(c)(2)] for an exception for any research and experimental expenditure allowable as a deduction under section 174 [26 USCS § 174] or the regulations thereunder. Additionally, section 263A [26 USCS § 263A] does not apply to any amount allowable as a deduction under section 59(e) [26 USCS § 59(e)] with respect to qualified expenditures under section 174 [26 USCS § 174].

**(10)**Certain property that is substantially constructed. Section 263A [26 USCS § 263A] does not apply to any property produced by a taxpayer for use in its trade or business if substantial construction occurred before March 1, 1986.

**(i)**For purposes of this section, substantial construction is deemed to have occurred if the lesser of --

**(A)**10 percent of the total estimated costs of construction; or

**(B)**The greater of $ 10 million or 2 percent of the total estimated costs of construction, was incurred before March 1, 1986.

**(ii)**For purposes of the provision in paragraph (b)(10)(i) of this section, the total estimated costs of construction shall be determined by reference to a reasonable estimate, on or before March 1, 1986, of such amount. Assume, for example, that on March 1, 1986, the estimated costs of constructing a facility were $ 150 million. Assume that before March 1, 1986, $ 12 million of construction costs had been incurred. Based on the above facts, substantial construction would be deemed to have occurred before March 1, 1986, because $ 12 million (the costs of construction incurred before such date) is greater than $ 10 million (the lesser of $ 15 million; or the greater of $ 10 million or $ 3 million). For purposes of this provision, construction costs are defined as those costs incurred after construction has commenced at the site of the property being constructed (unless the property will not be located on land and, therefore, the initial construction of the property must begin at a location other than the intended site). For example, in the case of a building, construction commences when work begins on the building, such as the excavation of the site, the pouring of pads for the building, or the driving of foundation pilings into the ground. Preliminary activities such as project engineering and architectural design do not constitute the commencement of construction, nor are such costs considered construction costs, for purposes of this paragraph (b)(10).

**(11)**Certain property provided incident to services --

**(i)**In general. Under this paragraph (b)(11), section 263A [26 USCS § 263A] does not apply to property that is provided to a client (or customer) incident to the provision of services by the taxpayer if the property provided to the client is --

**(A)**De minimis in amount; and

**(B)**Not inventory in the hands of the service provider.

**(ii)**Definition of services. For purposes of this paragraph (b)(11), services is defined with reference to its ordinary and accepted meaning under federal income tax principles. In determining whether a taxpayer is a bona-fide service provider under this paragraph (b)(11), the nature of the taxpayer's trade or business and the facts and circumstances surrounding the taxpayer's trade or business activities must be considered. Examples of taxpayers qualifying as service providers under this paragraph include taxpayers performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

**(iii)**De minimis property provided incident to services. In determining whether property provided to a client by a service provider is de minimis in amount, all facts and circumstances, such as the nature of the taxpayer's trade or business and the volume of its service activities in the trade or business, must be considered. A significant factor in making this determination is the relationship between the acquisition or direct materials costs of the property that is provided to clients and the price that the taxpayer charges its clients for its services and the property. For purposes of this paragraph (b)(11), if the acquisition or direct materials cost of the property provided to a client incident to the services is less than or equal to five percent of the price charged to the client for the services and property, the property is de minimis. If the acquisition or direct materials cost of the property exceeds five percent of the price charged for the services and property, the property may be de minimis if additional facts and circumstances so indicate.

**(12)**De minimis rule for certain producers with total indirect costs of $ 200,000 or less. See § 1.263A-2(b)(3)(iv) for a de minimis rule that treats producers with total indirect costs of $ 200,000 or less as having no additional section 263A [26 USCS § 263A] costs (as defined in paragraph (d)(3) of this section) for purposes of the simplified production method.

**(13)**Exception for the origination of loans. For purposes of section 263A(b)(2)(A) [26 USCS § 263A(b)(2)(A)], the origination of loans is not considered the acquisition of intangible property for resale. (But section 263A(b)(2)(A) [26 USCS § 263A(b)(2)(A)] does include the acquisition by a taxpayer of pre-existing loans from other persons for resale.)

**(c)**General operation of section 263A [26 USCS § 263A] --

**(1)**Allocations. Under section 263A [26 USCS § 263A], taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to property produced or property acquired for resale. In order to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production or resale activities. After section 263A [26 USCS § 263A] costs are allocated to the appropriate production or resale activities, these costs are generally allocated to the items of property produced or property acquired for resale during the taxable year and capitalized to the items that remain on hand at the end of the taxable year. See however, the simplified production method and the simplified resale method in §§ 1.263A-2(b) and 1.263A-3(d).

**(2)**Otherwise deductible.

**(i)**Any cost which (but for section 263A [26 USCS § 263A] and the regulations thereunder) may not be taken into account in computing taxable income for any taxable year is not treated as a cost properly allocable to property produced or acquired for resale under section 263A [26 USCS § 263A] and the regulations thereunder. Thus, for example, if a business meal deduction is limited by section 274(n) [26 USCS § 274(n)] to 80 percent of the cost of the meal, the amount properly allocable to property produced or acquired for resale under section 263A [26 USCS § 263A] is also limited to 80 percent of the cost of the meal.

**(ii)**The amount of any cost required to be capitalized under section 263A [26 USCS § 263A] may not be included in inventory or charged to capital accounts or basis any earlier than the taxable year during which the amount is incurred within the meaning of § 1.446-1(c)(1)(ii).

**(3)**Capitalize. Capitalize means, in the case of property that is inventory in the hands of a taxpayer, to include in inventory costs and, in the case of other property, to charge to a capital account or basis.

**(4)**Recovery of capitalized costs. Costs that are capitalized under section 263A [26 USCS § 263A] are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Internal Revenue Code and regulation provisions relating to use, sale, or disposition of property.

**(5)**Costs allocable to property sold. A cost that is allocated under this section, § 1.263A-2, or § 1.263A-3 entirely to property sold must be included in cost of goods sold and may not be included in determining the cost of goods on hand at the end of the taxable year.

**(d)**Definitions --

**(1)**Self-constructed assets. Self-constructed assets are assets produced by a taxpayer for use by the taxpayer in its trade or business. Self-constructed assets are subject to section 263A [26 USCS § 263A].

**(2)**Section 471 [26 USCS § 471] costs --

**(i)**In general. Except as otherwise provided in paragraphs (d)(2)(ii) and (iii) of this section, for purposes of the regulations under section 263A [26 USCS § 263A], a taxpayer's section 471 [26 USCS § 471] costs are the costs, other than interest, capitalized under its method of accounting immediately prior to the effective date of section 263A [26 USCS § 263A]. Thus, although section 471 [26 USCS § 471] applies only to inventories, section 471 [26 USCS § 471] costs include any non-inventory costs, other than interest, capitalized or included in acquisition or production costs under the taxpayer's method of accounting immediately prior to the effective date of section 263A [26 USCS § 263A].

**(ii)**New taxpayers. In the case of a new taxpayer, section 471 [26 USCS § 471] costs are those acquisition or production costs, other than interest, that would have been required to be capitalized by the taxpayer if the taxpayer had been in existence immediately prior to the effective date of section 263A [26 USCS § 263A].

**(iii)**Method changes. If a taxpayer included a cost described in § 1.471-11(c)(2)(iii) in its inventoriable costs immediately prior to the effective date of section 263A [26 USCS § 263A], that cost is included in the taxpayer's section 471 [26 USCS § 471] costs under paragraph (d)(2)(i) of this section. Except as provided in the following sentence, a change in the financial reporting practices of a taxpayer for costs described in § 1.471-11(c)(2)(iii) subsequent to the effective date of section 263A [26 USCS § 263A] does not affect the classification of these costs as section 471 [26 USCS § 471] costs. A taxpayer may change its established methods of accounting used in determining section 471 [26 USCS § 471] costs only with the consent of the Commissioner as required under section 446(e) [26 USCS § 446(e)] and the regulations thereunder.

**(3)**Additional section 263A [26 USCS § 263A] costs. Additional section 263A [26 USCS § 263A] costs are defined as the costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A [26 USCS § 263A] (adjusted as appropriate for any changes in methods of accounting for section 471 [26 USCS § 471] costs under paragraph (d)(2)(iii) of this section), but that are required to be capitalized under section 263A [26 USCS § 263A]. For new taxpayers, additional section 263A [26 USCS § 263A] costs are defined as the costs, other than interest, that the taxpayer must capitalize under section 263A [26 USCS § 263A], but which the taxpayer would not have been required to capitalize if the taxpayer had been in existence prior to the effective date of section 263A [26 USCS § 263A].

**(4)**Section 263A [26 USCS § 263A] costs. Section 263A [26 USCS § 263A] costs are defined as the costs that a taxpayer must capitalize under section 263A [26 USCS § 263A]. Thus, section 263A [26 USCS § 263A] costs are the sum of a taxpayer's section 471 [26 USCS § 471] costs, its additional section 263A [26 USCS § 263A] costs, and interest capitalizable under section 263A(f) [26 USCS § 263A(f)].

**(e)**Types of costs subject to capitalization --

**(1)**In general. Taxpayers subject to section 263A [26 USCS § 263A] must capitalize all direct costs and certain indirect costs properly allocable to property produced or property acquired for resale. This paragraph (e) describes the types of costs subject to section 263A [26 USCS § 263A].

**(2)**Direct costs --

**(i)**Producers. Producers must capitalize direct material costs and direct labor costs.

**(A)**Direct material costs. Direct materials costs include the cost of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced. For example, a cost described in § 1.162-3, relating to the cost of a material or supply, may be a direct material cost.

**(B)**Direct labor costs include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced. For this purpose, labor encompasses full-time and part-time employees, as well as contract employees and independent contractors. Direct labor costs include all elements of compensation other than employee benefit costs described in paragraph (e)(3)(ii)(D) of this section. Elements of direct labor costs include basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) [26 USCS § 105(d)] as it existed prior to its repeal in 1983), shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan.

**(ii)**Resellers. Resellers must capitalize the acquisition costs of property acquired for resale. In the case of inventory, the acquisition cost is the cost described in § 1.471-3(b).

**(3)**Indirect costs--

**(i)**In general.

**(A)**Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Taxpayers subject to section 263A [26 USCS § 263A] must capitalize all indirect costs properly allocable to property produced or property acquired for resale. Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Indirect costs may directly benefit or be incurred by reason of the performance of production or resale activities even if the costs are calculated as a percentage of revenue or gross profit from the sale of inventory, are determined by reference to the number of units of property sold, or are incurred only upon the sale of inventory. Indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject to section 263A [26 USCS § 263A]. Taxpayers must make a reasonable allocation of indirect costs between production, resale, and other activities.

**(B)**Example. The following example illustrates the provisions of this paragraph (e)(3)(i):

Example.

**(i)**Taxpayer A manufactures tablecloths and other linens. A enters into a licensing agreement with Company L under which A may label its tablecloths with L's trademark if the tablecloths meet certain specified quality standards. In exchange for its right to use L's trademark, the licensing agreement requires A to pay L a royalty of for each tablecloth carrying L's trademark that A sells. The licensing agreement does not require A to pay L any minimum or lump-sum royalties.

**(ii)**The licensing agreement provides A with the right to use L's intellectual property, a trademark. The licensing agreement also requires A to conduct its production activities according to certain standards as a condition of exercising that right. Thus, A's right to use L's trademark under the licensing agreement is directly related to A's production of tablecloths. The royalties the licensing agreement requires A to pay for using L's trademark are the costs A incurs in exchange for these rights. Therefore, although A incurs royalty costs only when A sells a tablecloth carrying L's trademark, the royalty costs directly benefit production activities and are incurred by reason of production activities within the meaning of paragraph (e)(3)(i)(A) of this section.

**(ii)**Examples of indirect costs required to be capitalized. The following are examples of indirect costs that must be capitalized to the extent they are properly allocable to property produced or property acquired for resale:

**(A)**Indirect labor costs. Indirect labor costs include all labor costs (including the elements of labor costs set forth in paragraph (e)(2)(i) of this section) that cannot be directly identified or associated with particular units or groups of units of specific property produced or property acquired for resale (e.g., factory labor that is not direct labor). As in the case of direct labor, indirect labor encompasses full-time and part-time employees, as well as contract employees and independent contractors.

**(B)**Officers' compensation. Officers' compensation includes compensation paid to officers of the taxpayer.

**(C)**Pension and other related costs. Pension and other related costs include contributions paid to or made under any stock bonus, pension, profit-sharing or annuity plan, or other plan deferring the receipt of compensation, whether or not the plan qualifies under section 401(a) [26 USCS § 401(a)]. Contributions to employee plans representing past services must be capitalized in the same manner (and in the same proportion to property currently being acquired or produced) as amounts contributed for current service.

**(D)**Employee benefit expenses. Employee benefit expenses include all other employee benefit expenses (not described in paragraph (e)(3)(ii)(C) of this section) to the extent such expenses are otherwise allowable as deductions under chapter 1 of the Internal Revenue Code. These other employee benefit expenses include: worker's compensation; amounts otherwise deductible or allowable in reducing earnings and profits under section 404A [26 USCS § 404A]; payments pursuant to a wage continuation plan under section 105(d) [26 USCS § 105(d)] as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation that has the effect of a stock bonus, pension, profit-sharing or annuity plan, or other plan deferring receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, etc. Employee benefit expenses do not, however, include direct labor costs described in paragraph (e)(2)(i) of this section.

**(E)**Indirect material costs. Indirect material costs include the cost of materials that are not an integral part of specific property produced and the cost of materials that are consumed in the ordinary course of performing production or resale activities that cannot be identified or associated with particular units of property. Thus, for example, a cost described in § 1.162-3, relating to the cost of a material or supply, may be an indirect cost.

**(F)**Purchasing costs. Purchasing costs include costs attributable to purchasing activities. See § 1.263A-3(c)(3) for a further discussion of purchasing costs.

**(G)**Handling costs. Handling costs include costs attributable to processing, assembling, repackaging and transporting goods, and other similar activities. See § 1.263A-3(c)(4) for a further discussion of handling costs.

**(H)**Storage costs. Storage costs include the costs of carrying, storing, or warehousing property. See § 1.263A-3(c)(5) for a further discussion of storage costs.

**(I)**Cost recovery. Cost recovery includes depreciation, amortization, and cost recovery allowances on equipment and facilities (including depreciation or amortization of self-constructed assets or other previously produced or acquired property to which section 263A [26 USCS § 263A] or section 263 [26 USCS § 263] applies).

**(J)**Depletion. Depletion includes allowances for depletion, whether or not in excess of cost. Depletion is, however, only properly allocable to property that has been sold (i.e., for purposes of determining gain or loss on the sale of the property).

**(K)**Rent. Rent includes the cost of renting or leasing equipment, facilities, or land.

**(L)**Taxes. Taxes include those taxes (other than taxes described in paragraph (e)(3)(iii)(F) of this section) that are otherwise allowable as a deduction to the extent such taxes are attributable to labor, materials, supplies, equipment, land, or facilities used in production or resale activities.

**(M)**Insurance. Insurance includes the cost of insurance on plant or facility, machinery, equipment, materials, property produced, or property acquired for resale.

**(N)**Utilities. Utilities include the cost of electricity, gas, and water.

**(O)**Repairs and maintenance. Repairs and maintenance include the cost of repairing and maintaining equipment or facilities.

**(P)**Engineering and design costs. Engineering and design costs include pre-production costs, such as costs attributable to research, experimental, engineering, and design activities (to the extent that such amounts are not research and experimental expenditures as described in section 174 [26 USCS § 174] and the regulations thereunder).

**(Q)**Spoilage. Spoilage includes the costs of rework labor, scrap, and spoilage.

**(R)**Tools and equipment. Tools and equipment include the costs of tools and equipment which are not otherwise capitalized.

**(S)**Quality control. Quality coontrol includes the costs of quality control and inspection.

**(T)**Bidding costs. Bidding costs are costs incurred in the solicitation of contracts (including contracts pertaining to property acquired for resale) ultimately awarded to the taxpayer. The taxpayer must defer all bidding costs paid or incurred in the solicitation of a particular contract until the contract is awarded. If the contract is awarded to the taxpayer, the bidding costs become part of the indirect costs allocated to the subject matter of the contract. If the contract is not awarded to the taxpayer, bidding costs are deductible in the taxable year that the contract is awarded to another party, or in the taxable year that the taxpayer is notified in writing that no contract will be awarded and that the contract (or a similar or related contract) will not be rebid, or in the taxable year that the taxpayer abandons its bid or proposal, whichever occurs first. Abandoning a bid does not include modifying, supplementing, or changing the original bid or proposal. If the taxpayer is awarded only part of the bid (for example, the taxpayer submitted one bid to build each of two different types of products, and the taxpayer was awarded a contract to build only one of the two types of products), the taxpayer shall deduct the portion of the bidding costs related to the portion of the bid not awarded to the taxpayer. In the case of a bid or proposal for a multi-unit contract, all bidding costs must be included in the costs allocated to the subject matter of the contract awarded to the taxpayer to produce or acquire for resale any of such units. For example, where the taxpayer submits one bid to produce three similar turbines and the taxpayer is awarded a contract to produce only two of the three turbines, all bidding costs must be included in the cost of the two turbines. For purposes of this paragraph (e)(3)(ii)(T), a contract means --

> **(1)**In the case of a specific unit of property, any agreement under which the taxpayer would produce or sell property to another party if the agreement is entered into before the taxpayer produces or acquires the specific unit of property to be delivered to the party under the agreement; and
>
> **(2)**In the case of fungible property, any agreement to the extent that, at the time the agreement is entered into, the taxpayer has on hand an insufficient quantity of completed fungible items of such property that may be used to satisfy the agreement (plus any other production or sales agreements of the taxpayer).

**(U)**Licensing and franchise costs.

**(1)**Licensing and franchise costs include fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced or property acquired for resale. These costs include the otherwise deductible portion (such as amortization) of the initial fees incurred to obtain the license or franchise and any minimum annual payments and any royalties that are incurred by a licensee or a franchisee. These costs also include fees, payments, and royalties otherwise described in this paragraph (e)(3)(ii)(U) that a taxpayer incurs (within the meaning of section 461 [26 USCS § 461]) only upon the sale of property produced or acquired for resale.

**(2)**If a taxpayer incurs (within the meaning of section 461 [26 USCS § 461]) a fee, payment, or royalty described in this paragraph (e)(3)(ii)(U) only upon the sale of property produced or acquired for resale and the cost is required to be capitalized under this paragraph (e)(3), the taxpayer may properly allocate the cost entirely to property produced or acquired for resale by the taxpayer that has been sold.

**(V)**Interest. Interest includes interest on debt incurred or continued during the production period to finance the production of real property or tangible personal property to which section 263A(f) [26 USCS § 263A(f)] applies.

**(W)**Capitalizable service costs. Service costs that are required to be capitalized include capitalizable service costs and capitalizable mixed service costs as defined in paragraph (e)(4) of this section.

**(iii)**Indirect costs not capitalized. The following indirect costs are not required to be capitalized under section 263A [26 USCS § 263A]:

**(A)**Selling and distribution costs. These costs are marketing, selling, advertising, and distribution costs.

**(B)**Research and experimental expenditures. Research and experimental expenditures are expenditures described in section 174 [26 USCS § 174] and the regulations thereunder.

**(C)**Section 179 [26 USCS § 179] costs. Section 179 [26 USCS § 179] costs are expenses for certain depreciable assets deductible at the election of the taxpayer under section 179 [26 USCS § 179] and the regulations thereunder.

**(D)**Section 165 [26 USCS § 165] losses. Section 165 [26 USCS § 165] losses are losses under section 165 [26 USCS § 165] and the regulations thereunder.

**(E)**Cost recovery allowances on temporarily idle equipment and facilities --

**(1)**In general. Cost recovery allowances on temporarily idle equipment and facilities include only depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle. Equipment and facilities are temporarily idle when a taxpayer takes them out of service for a finite period. However, equipment and facilities are not considered temporarily idle --

**(i)**During worker breaks, non-working hours, or on regularly scheduled non-working days (such as holidays or weekends);

**(ii)**During normal interruptions in the operation of the equipment or facilities;

**(iii)**When equipment is enroute to or located at a job site; or

**(iv)**When under normal operating conditions, the equipment is used or operated only during certain shifts.

**(2)**Examples. The provisions of this paragraph (e)(3)(iii)(E) are illustrated by the following examples:

Example 1. Equipment operated only during certain shifts. Taxpayer A manufactures widgets. Although A's manufacturing facility operates 24 hours each day in three shifts, A only operates its stamping machine during one shift each day. Because A only operates its stamping machine during certain shifts, A's stamping machine is not considered temporarily idle during the two shifts that it is not operated.

Example 2. Facility shut down for retooling. Taxpayer B owns and operates a manufacturing facility. B closes its manufacturing facility for two weeks to retool its assembly line. B's manufacturing facility is considered temporarily idle during this two-week period.

**(F)**Taxes assessed on the basis of income. Taxes assessed on the basis of income include only state, local, and foreign income taxes, and franchise taxes that are assessed on the taxpayer based on income.

**(G)**Strike expenses. Strike expenses include only costs associated with hiring employees to replace striking personnel (but not wages of replacement personnel), costs of security, and legal fees associated with settling strikes.

**(H)**Warranty and product liability costs. Warranty costs and product liability costs are costs incurred in fulfilling product warranty obligations for products that have been sold and costs incurred for product liability insurance.

**(I)**On-site storage costs. On-site storage costs are storage and warehousing costs incurred by a taxpayer at an on-site storage facility, as defined in § 1.263A-3(c)(5)(ii)(A), with respect to property produced or property acquired for resale.

**(J)**Unsuccessful bidding expenses. Unsuccessful bidding costs are bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer.

**(K)**Deductible service costs. Service costs that are not required to be capitalized include deductible service costs and deductible mixed service costs as defined in paragraph (e)(4) of this section.

**(4)**Service costs --

**(i)**Introduction. This paragraph (e)(4) provides definitions and categories of service costs. Paragraph (g)(4) of this section provides specific rules for determining the amount of service costs allocable to property produced or property acquired for resale. In addition, paragraph (h) of this section provides a simplified method for determining the amount of service costs that must be capitalized.

**(A)**Definition of service costs. Service costs are defined as a type of indirect costs (e.g., general and administrative costs) that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function.

**(B)**Definition of service departments. Service departments are defined as administrative, service, or support departments that incur service costs. The facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. For example, service departments include personnel, accounting, data processing, security, legal, and other similar departments.

**(ii)**Various service cost categories --

**(A)**Capitalizable service costs. Capitalizable service costs are defined as service costs that directly benefit or are incurred by reason of the performance of the production or resale activities of the taxpayer. Therefore, these service costs are required to be capitalized under section 263A [26 USCS § 263A]. Examples of service departments or functions that incur capitalizable service costs are provided in paragraph (e)(4)(iii) of this section.

**(B)**Deductible service costs. Deductible service costs are defined as service costs that do not directly benefit or are not incurred by reason of the performance of the production or resale activities of the taxpayer, and therefore, are not required to be capitalized under section 263A [26

USCS § 263A]. Deductible service costs generally include costs incurred by reason of the taxpayer's overall management or policy guidance functions. In addition, deductible service costs include costs incurred by reason of the marketing, selling, advertising, and distribution activities of the taxpayer. Examples of service departments or functions that incur deductible service costs are provided in paragraph (e)(4)(iv) of this section.

**(C)**Mixed service costs. Mixed service costs are defined as service costs that are partially allocable to production or resale activities (capitalizable mixed service costs) and partially allocable to non-production or non-resale activities (deductible mixed service costs). For example, a personnel department may incur costs to recruit factory workers, the costs of which are allocable to production activities, and it may incur costs to develop wage, salary, and benefit policies, the costs of which are allocable to non-production activities.

**(iii)**Examples of capitalizable service costs. Costs incurred in the following departments or functions are generally allocated among production or resale activities:

**(A)**The administration and coordination of production or resale activities (wherever performed in the business organization of the taxpayer).

**(B)**Personnel operations, including the cost of recruiting, hiring, relocating, assigning, and maintaining personnel records or employees.

**(C)**Purchasing operations, including purchasing materials and equipment, scheduling and coordinating delivery of materials and equipment to or from factories or job sites, and expediting and follow-up.

**(D)**Materials handling and warehousing and storage operations.

**(E)**Accounting and data services operations, including, for example, cost accounting, accounts payable, disbursements, and payroll functions (but excluding accounts receivable and customer billing functions).

**(F)**Data processing.

**(G)**Security services.

**(H)**Legal services.

**(iv)**Examples of deductible service costs. Costs incurred in the following departments or functions are not generally allocated to production or resale activities:

**(A)**Departments or functions responsible for overall management of the taxpayer or for setting overall policy for all of the taxpayer's activities or trades or businesses, such as the board of directors (including their immediate staff), and the chief executive, financial, accounting, and legal officers (including their immediate staff) of the taxpayer, provided that no substantial part of the cost of such departments or functions benefits a particular production or resale activity.

**(B)**Strategic business planning.

**(C)**General financial accounting.

**(D)**General financial planning (including general budgeting) and financial management (including bank relations and cash management).

**(E)**Personnel policy (such as establishing and managing personnel policy in general; developing wage, salary, and benefit policies; developing employee training programs unrelated to particular production or resale activities; negotiating with labor unions; and maintaining relations with retired workers).

**(F)**Quality control policy.

**(G)**Safety engineering policy.

**(H)**Insurance or risk management policy (but not including bid or performance bonds or insurance related to activities associated with property produced or property acquired for resale).

**(I)**Environmental management policy (except to the extent that the costs of any system or procedure benefits a particular production or resale activity).

**(J)**General economic analysis and forecasting.

**(K)**Internal audit.

**(L)**Shareholder, public, and industrial relations.

**(M)**Tax services.

**(N)**Marketing, selling, or advertising.

**(f)**Cost allocation methods --

**(1)**Introduction. This paragraph (f) sets forth various detailed or specific (facts-and-circumstances) cost allocation methods that taxpayers may use to allocate direct and indirect costs to property produced and property acquired for resale. Paragraph (g) of this section provides general rules for applying these allocation methods to various categories of costs (i.e., direct materials, direct labor, and indirect costs, including service costs). In addition, in lieu of a facts-and-circumstances allocation method, taxpayers may use the simplified methods provided in §§ 1.263A-2(b) and 1.263A-3(d) to allocate direct and indirect costs to eligible property produced or eligible property acquired for resale; see those sections for definitions of eligible property. Paragraph (h) of this section provides a simplified method for determining the amount of mixed service costs required to be capitalized to eligible property. The methodology set forth in paragraph (h) of this section for mixed service costs may be used in conjunction with either a facts-and-circumstances or a simplified method of allocating costs to eligible property produced or eligible property acquired for resale.

**(2)**Specific identification method. A specific identification method traces costs to a cost objective, such as a function, department, activity, or product, on the basis of a cause and effect or other reasonable relationship between the costs and the cost objective.

**(3)**Burden rate and standard cost methods --

**(i)**Burden rate method --

**(A)**In general. A burden rate method allocates an appropriate amount of indirect costs to property produced or property acquired for resale during a taxable year using predetermined rates that approximate the actual amount of indirect costs incurred by the taxpayer during the taxable year. Burden rates (such as ratios based on direct costs, hours, or similar items) may be developed by the taxpayer in accordance with acceptable accounting principles and applied in a reasonable manner. A taxpayer may allocate different indirect costs on the basis of different burden rates. Thus, for example, the taxpayer may use one burden rate for allocating the cost of rent and another burden rate for allocating the cost of utilities. Any periodic adjustment to a burden rate that merely reflects current operating conditions, such as increases in automation or changes in operation or prices, is not a change in method of accounting under section 446(e) [26 USCS § 446(e)]. A change, however, in the concept or base upon which such rates are developed, such as a change from basing the rates on direct labor hours to basing them on direct machine hours, is a change in method of accounting to which section 446(e) [26 USCS § 446(e)] applies.

**(B)**Development of burden rates. The following factors, among others, may be used in developing burden rates:

**(1)**The selection of an appropriate level of activity and a period of time upon which to base the calculation of rates reflecting operating conditions for purposes of the unit costs being determined.

**(2)**The selection of an appropriate statistical base, such as direct labor hours, direct labor dollars, machine hours, or a combination thereof, upon which to apply the overhead rate.

**(3)**The appropriate budgeting, classification, and analysis of expenses (for example, the analysis of fixed versus variable costs).

**(C)**Operation of the burden rate method. The purpose of the burden rate method is to allocate an appropriate amount of indirect costs to production or resale activities through the use of predetermined rates intended to approximate the actual amount of indirect costs incurred. Accordingly, the proper use of the burden rate method under this section requires that any net negative or net positive difference between the total predetermined amount of costs allocated to property and the total amount of indirect costs actually incurred and required to be allocated to such property (i.e., the under or over-applied burden) must be treated as an adjustment to the taxpayer's ending inventory or capital account (as the case may be) in the taxable year in which such difference arises. However, if such adjustment is not significant in amount in relation to the taxpayer's total indirect costs incurred with respect to production or resale activities for the year, such adjustment need not be allocated to the property produced or property acquired for resale unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative adjustments consistently.

**(ii)**Standard cost method --

**(A)**In general.A standard cost method allocates an appropriate amount of direct and indirect costs to property produced by the taxpayer through the use of preestablished standard allowances, without reference to costs actually incurred during the taxable year. A taxpayer may use a standard cost method to allocate costs, provided variances are treated in accordance with the procedures prescribed in paragraph (f)(3)(ii)(B) of this section. Any periodic adjustment to standard costs that merely reflects current ooperating conditions, such as increases in automation or changes in operation or prices, is not a change in method of accounting under section 446(e) [26 USCS § 446(e)]. A change, however, in the concept or base upon which standard costs are developed is a change in method of accounting to which section 446(e) [26 USCS § 446(e)] applies.

**(B)**Treatment of variances. For purposes of this section, net positive overhead variance means the excess of total standard indirect costs over total actual indirect costs and net negative overhead variance means the excess of total actual indirect costs over total standard indirect costs. The proper use of a standard cost method requires that a taxpayer must reallocate to property a pro rata portion of any net negative or net positive overhead variances and any net negative or net positive direct cost variances. The taxpayer must apportion such variances to or among the property to which the costs are allocable. However, if such variances are not significant in amount relative to the taxpayer's total indirect costs incurred with respect to production and resale activities for the year, such variances need not be allocated to property produced or property acquired for resale unless such allocation is made in the taxpayer's financial reports. A taxpayer must treat both positive and negative variances consistently.

**(4)**Reasonable allocation methods. A taxpayer may use the methods described in paragraph (f) (2) or (3) of this section if they are reasonable allocation methods within the meaning of this paragraph (f)(4). In addition, a taxpayer may use any other reasonable method to properly allocate direct and indirect costs among units of property produced or property acquired for resale during the taxable year. An allocation method is reasonable if, with respect to the taxpayer's production or resale activities taken as a whole --

**(i)**The total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in this section or in §§ 1.263A-2 and 1.263A-3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocation methods;

**(ii)**The allocation method is applied consistently by the taxpayer; and

**(iii)**The allocation method is not used to circumvent the requirements of the simplified methods in this section or in § 1.263A-2, § 1.263A-3, or the principles of section 263A [26 USCS § 263A].

**(g)**Allocating categories of costs --

**(1)**Direct materials. Direct material costs (as defined in paragraph (e)(2) of this section) incurred during the taxable year must be allocated to the property produced or property acquired for resale by the taxpayer using the taxpayer's method of accounting for materials (e.g., specific identification; first-in, first-out (FIFO); or last-in, first-out (LIFO)), or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

**(2)**Direct labor. Direct labor costs (as defined in paragraph (e)(2) of this section) incurred during the taxable year are generally allocated to property produced or property acquired for resale using a specific identification method, standard cost method, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section). All elements of compensation, other than basic compensation, may be grouped together and then allocated in proportion to the charge for basic compensation. Further, a taxpayer is not treated as using an erroneous method of accounting if direct labor costs are treated as indirect costs under the taxpayer's allocation method, provided such costs are capitalized to the extent required by paragraph (g)(3) of this section.

**(3)**Indirect costs. Indirect costs (as defined in paragraph (e)(3) of this section) are generally allocated to intermediate cost objectives such as departments or activities prior to the allocation of such costs to property produced or property acquired for resale. Indirect costs are allocated using either a specific identification method, a standard cost method, a burden rate method, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

**(4)**Service costs --

**(i)**In general. Service costs are a type of indirect costs that may be allocated using the same allocation methods available for allocating other indirect costs described in paragraph (g)(3) of this section. Generally, taxpayers that use a specific identification method or another reasonable allocation method must allocate service costs to particular departments or activities based on a factor or relationship that reasonably relates the service costs to the benefits received from the service departments or activities. For example, a reasonable factor for allocating legal services to particular departments or activities is the number of hours of legal services attributable to each department or activity. See paragraph (g)(4)(iv) of this section for other illustrations. Using reasonable factors or relationships, a taxpayer must allocate mixed service costs under a direct reallocation method described in paragraph (g)(4)(iii)(A) of this section, a step-allocation method described in paragraph (g)(4)(iii)(B) of this section, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

**(ii)**De minimis rule. For purposes of administrative convenience, if 90 percent or more of a mixed service department's costs are deductible service costs, a taxpayer may elect not to allocate any portion of the service department's costs to property produced or property acquired for resale. For example, if 90 percent of the costs of an electing taxpayer's industrial relations department benefit the taxpayer's overall policy-making activities, the taxpayer is not required to allocate any portion of these costs to a production activity. Under this election, however, if 90 percent or more of a mixed service department's costs are capitalizable service costs, a taxpayer must allocate 100 percent of the department's costs to the production or resale activity benefitted. For example, if 90 percent of the costs of an electing taxpayer's accounting department benefit the taxpayer's manufacturing activity, the taxpayer must allocate 100 percent of the costs of the accounting department to the manufacturing activity. An election under this paragraph (g)(4)(ii) applies to all of a taxpayer's mixed service departments and constitutes the adoption of a (or a change in) method of accounting under section 446 of the Internal Revenue Code [26 USCS § 446].

**(iii)**Methods for allocating mixed service costs --

**(A)**Direct reallocation method. Under the direct reallocation method, the total costs (direct and indirect) of all mixed service departments are allocated only to departments or cost centers engaged in production or resale activities and then from those departments to particular activities. This direct reallocation method ignores benefits provided by one mixed service department to other mixed service departments, and also excludes other mixed service departments from the base used to make the allocation.

**(B)**Step-allocation method.

**(1)**Under a step-allocation method, a sequence of allocations is made by the taxpayer. First, the total costs of the mixed service departments that benefit the greatest number of other departments are allocated to --

**(i)**Other mixed service departments;

**(ii)**Departments that incur only deductible service costs; and

**(iii)**Departments that exclusively engage in production or resale activities.

**(2)**A taxpayer continues allocating mixed service costs in the manner described in paragraph (g)(4)(iii)(B)(1) of this section (i.e., from the service departments benefitting the greatest number of departments to the service departments benefitting the least number of departments) until all mixed service costs are allocated to the types of departments listed in this paragraph (g)(4)(iii). Thus, a step-allocation method recognizes the benefits provided by one mixed service department to another mixed service department and also includes mixed service departments that have not yet been allocated in the base used to make the allocation.

**(C)**Examples. The provisions of this paragraph (g)(4)(iii) are illustrated by the following examples:

Example 1. Direct reallocation method.

**(i)**Taxpayer E has the following five departments: the Assembling Department, the Painting Department, and the Finishing Department (production departments), and the Personnel Department and the Data Processing Department (mixed service departments). E allocates the Personnel Department's costs on the basis of total payroll costs and the Data Processing Department's costs on the basis of data processing hours.

**(ii)**Under a direct reallocation method, E allocates the Personnel Department's costs directly to its Assembling, Painting, and Finishing Department, and not to its Data Processing department.

| Department | Total dept. costs | Amount of payroll costs | Allocation ratio | Amount allocated |
|---|---|---|---|---|
| Personnel | $ 500,000 | $ 50,000 | | <$ 500,000> |
| Data Proc'g | 250,000 | 15,000 | | |
| Assembling | 250,000 | 15,000 | 15,000/285,000 | 26,315 |
| Painting | 1,000,000 | 90,000 | 90,000/285,000 | 157,895 |
| Finishing | 2,000,000 | 180,000 | 180,000/285,000 | 315,790 |
| Total | $ 4,000,000 | $ 350,000 | | |

**(iii)**After E allocates the Personnel Department's costs, E then allocates the costs of its Data Processing Department in the same manner.

| Department | Total dept. cost after | Total data | Allocation | Amount | Total dept. cost after |
|---|---|---|---|---|---|

| | initial allocation | proc. hours | ratio | allocated | final allocation |
|---|---|---|---|---|---|
| Personnel | 0 | 2,000 | | | 0 |
| Data Proc'g | $ 250,000 | | | <$ 250,000> | |
| Assembling | 276,315 | 2,000 | 2,000/10,000 | 50,000 | $ 326,315 |
| Painting | 1,157,895 | 0 | 0/10,000 | 0 | 1,157,895 |
| Finishing | 2,315,790 | 8,000 | 8,000/10,000 | 200,000 | 2,515,790 |
| Total | $ 4,000,000 | 12,000 | | | $ 4,000,000 |

Example 2. Step-allocation method.

**(i)**Taxpayer F has the following five departments: the Manufacturing Department (a production department), the Marketing Department and the Finance Department (departments that incur only deductible service costs), the Personnel Department and the Data Processing Department (mixed service departments). F uses a step-allocation method and allocates the Personnel Department's costs on the basis of total payroll costs and the Data Processing Department's costs on the basis of data processing hours. F's Personnel Department benefits all four of F's other departments, while its Data Processing Department benefits only three departments. Because F's Personnel Department benefits the greatest number of other departments, F first allocates its Personnel Department's costs to its Manufacturing, Marketing, Finance and Data Processing departments, as follows:

| Department | Total cost of dept. | Total payroll costs | Allocation ratio | Amount allocated |
|---|---|---|---|---|
| Personnel | $ 500,000 | $ 50,000 | | <$ 500,000> |
| Data Proc'g | 250,000 | 15,000 | 15,000/300,000 | 25,000 |
| Finance | 250,000 | 15,000 | 15,000/300,000 | 25,000 |
| Marketing | 1,000,000 | 90,000 | 90,000/300,000 | 150,000 |
| Manufac'g | 2,000,000 | 180,000 | 180,000/300,000 | 300,000 |
| | 4,000,000 | 350,000 | | |

**(ii)**Under a step-allocation method, the denominator of F's allocation ratio includes the payroll costs of its Manufacturing, Marketing, Finance, and Data Processing departments.

**(iii)**Next, F allocates the costs of its Data Processing Department on the basis of data processing hours. Because the costs incurred by F's Personnel Department have already been allocated, no allocation is made to the Personnel Department.

| Department | Total dept. cost after initial | Total data proc. hours | Allocation |
|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| Personnel | $ 0 | 2,000 | | | $ 0 |
| Data Proc'g | 275,000 | | | <$ 275,000> | 0 |
| Finance | 275,000 | 2,000 | 2,000/10,000 | 55,000 | 330,000 |
| Marketing | 1,150,000 | 0 | 0/10,000 | 0 | 1,150,000 |
| Manufac'g | 2,300,000 | 8,000 | 8,000/10,000 | 220,000 | 2,520,000 |
| | 4,000,000 | 12,000 | | | 4,000,000 |

**(iv)**Under the second step of F's step-allocation method, the denominator of F's allocation ratio includes the data processing hours of its Manufacturing, Marketing, and Finance Departments, but does not include the data processing hours of its Personnel Department (the other mixed service department) because the costs of that department have previously been allocated.

**(iv)**Illustrations of mixed service cost allocations using reasonable factors or relationships. This paragraph (g)(4)(iv) illustrates various reasonable factors and relationships that may be used in allocating different types of mixed service costs. Taxpayers, however, are permitted to use other reasonable factors and relationships to allocate mixed service costs. In addition, the factors or relationships illustrated in this paragraph (g)(4)(iv) may be used to allocate other types of service costs not illustrated in this paragraph (g)(4)(iv).

**(A)**Security services. The costs of security or protection services must be allocated to each physical area that receives the services using any reasonable method applied consistently (e.g., the size of the physical area, the number of employees in the area, or the relative fair market value of assets located in the area).

**(B)**Legal services. The costs of legal services are generally allocable to a particular production or resale activity on the basis ofthe approximate number of hours of legal service performed in connection with the activity, including research, bidding, negotiating, drafting, reviewing a contract, obtaining necessary licenses and permits, and resolving disputes. Different hourly rates may be appropriate for different services. In determining the number of hours allocable to any activity, estimates are appropriate, detailed time records are not required to be kept, and insubstantial amounts of services provided to an activity by senior legal staff (such as administrators or reviewers) may be ignored. Legal costs may also be allocated to a particular production or resale activity based on the ratio of the total direct costs incurred for the activity to the total direct costs incurred with respect to all production or resale activities. The taxpayer must also allocate directly to an activity the cost incurred for any outside legal services. Legal costs relating to general corporate functions are not required to be allocated to a particular production or resale activity.

**(C)**Centralized payroll services. The costs of a centralized payroll department or activity are generally allocated to the departments or activities benefitted on the basis of the gross dollar amount of payroll processed.

**(D)**Centralized data processing services. The costs of a centralized data processing department are generally allocated to all departments or activities benefitted using any reasonable basis, such as total direct data processing costs or the number of data processing hours supplied. The costs of data processing systems or applications developed for a particular activity are directly allocated to that activity.

**(E)**Engineering and design services. The costs of an engineering or a design department are generally directly allocable to the departments or activities benefitted based on the ratio of the approximate number of hours of work performed with respect to the particular activity to the total number of hours of engineering or design work performed for all activities. Different services may be allocated at different hourly rates.

**(F)**Safety engineering services. The costs of a safety engineering departments or activities generally benefit all of the taxpayer's activities annd, thus, should be allocated using a reasonable basis, such as: the approximate number of safety inspections made in connection with a particular activity as a fraction of total inspections, the number of employees assigned to an activity as a fraction of total employees, or the total labor hours worked in connection with an activity as a fraction of total hours. However, in determining the allocable costs of a safety engineering department, costs attributable to providing a safety program relating only to a particular activity must be directly assigned to such activity. Additionally, the cost of a safety engineering department only responsible for setting safety policy and establishing safety procedures to be used in all of the taxpayer's activities is not required to be allocated.

**(v)**Accounting method change. A change in the method or base used to allocate service costs (such as changing from an allocation base using direct labor costs to a base using direct labor hours), or a change in the taxpayer's determination of what functions or departments of the taxpayer are to be allocated, is a change in method of accounting to which section 446(e) [26 USCS § 446(e)] and the regulations thereunder apply.

**(h)**Simplified service cost method --

**(1)**Introduction. This paragraph (h) provides a simplified method for determining capitalizable mixed service costs incurred during the taxable year with respect to eligible property (i.e., the aggregate portion of mixed service costs that are properly allocable to the taxpayer's production or resale activities).

**(2)**Eligible property --

**(i)**In general. Except as otherwise provided in paragraph (h)(2)(ii) of this section, the simplified service cost method, if elected for any trade or business of the taxpayer, must be used for all production and resale activities of the trade or business associated with any of the following categories of property that are subject to section 263A [26 USCS § 263A]:

**(A)**Inventory property. Stock in trade or other property properly includible in the inventory of the taxpayer.

**(B)**Non-inventory property held for sale. Non-inventory property held by a taxpayer primarily for sale to customers inthe ordinary course of the taxpayer's trade or business.

**(C)**Certain self-constructed assets. Self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer and held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

**(D)**Self-constructed tangible personal property produced on a routine and repetitive basis --

**(1)**In general. Self-constructed tangible personal property produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business. Self-constructed tangible personal property is produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business when units of tangible personal property (as defined in § 1.263A-10(c)) are mass-produced, that is, numerous substantially identical assets are manufactured within a taxable year using standardized designs and assembly line techniques, and either the applicable recovery period of the property determined under section 168(c) [26 USCS § 168(c)] is not longer than 3 years or the property is a material or supply that will be used and consumed within 3 years of being produced. For purposes of this paragraph (h)(2)(i)(D), the applicable recovery period of the assets will be determined at the end of the taxable year in which the assets are placed in service for purposes of § 1.46-3(d). Subsequent changes to the applicable recovery period after the assets are placed in service will not affect the determination of whether the assets are produced on a routine and repetitive basis for purposes of this paragraph (h)(2)(i)(D).

**(2)**Examples. The following examples illustrate this paragraph (h)(2)(i)(D):

Example 1. Y is a manufacturer of automobiles. During the taxable year Y produces numerous substantially identical dies and molds using standardized designs and assembly line techniques. The dies and molds have a 3-year applicable recovery period for purposes of section 168(c) [26 USCS § 168(c)]. Y uses the dies and molds to produce or process particular automobile components and does not hold them for sale. The dies and molds are produced on a routine and repetitive basis in the ordinary course of Y's business for purposes of this paragraph because the dies and molds are both mass-produced and have a recovery period of not longer than 3 years.

Example 2. Z is an electric utility that regularly manufactures and installs identical poles that are used in transmitting and distributing electricity. The poles have a 20-year applicable recovery period for purposes of section 168(c) [26 USCS § 168(c)]. The poles are not produced on a routine and repetitive basis in the ordinary course of Z's business for purposes of this paragraph because the poles have an applicable recovery period that is longer than 3 years.

**(ii)**Election to exclude self-constructed assets. At the taxpayer's election, the simplified service cost method may be applied within a trade or business to only the categories of inventory property and non-inventory property held for sale described in paragraphs (h)(2)(i) (A) and (B) of this section. Taxpayers electing to exclude the self-constructed assets described in paragraphs (h)(2)(i) (C) and (D) of this section from application of the simplified service cost method must, however, allocate service costs to such property in accordance with paragraph (g)(4) of this section.

**(3)**General allocation formula.

**(i)**Under the simplified service cost method, a taxpayer computes its capitalizable mixed service costs using the following formula:

Allocation ratio X total mixed service costs

**(ii)**A producer may elect one of two allocation ratios, the labor-based allocation ratio or the production cost allocation ratio. A reseller that satisfies the requirements for using the simplified resale method of § 1.263A-3(d) (whether or not that method is elected) may elect the simplified service cost method, but must use a labor-based allocation ratio. (See § 1.263A-3(d) for labor-based allocation ratios to be used in conjunction with the simplified resale method.) The allocation ratio used by a trade or business of a taxpayer is a method of accounting which must be applied consistently within the trade or business.

**(4)**Labor-based allocation ratio.

**(i)**The labor-based allocation ratio is computed as follows:

Section 263A [26 USCS § 263A] production costs

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Total labor costs

**(ii)**Section 263A [26 USCS § 263A] labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) allocable to property produced and property acquired for resale under section 263A [26 USCS § 263A] that are incurred in the taxpayer's trade or business during the taxable year. Total labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) incurred in the taxpayer's trade or business during the taxable year. Total labor costs include labor costs incurred in all parts of the trade or business (i.e., if the taxpayer has both property produced and property acquired for resale, the taxpayer must include labor costs from resale activities as well as production activities). For example, taxpayer G incurs $ 1,000 of total mixed service costs during the taxable year. G's section 263A [26 USCS § 263A] labor costs are $ 5,000 and its total labor costs are $ 10,000. Under the labor-based allocation ratio, G's capitalizable mixed service costs are $ 500 (i.e., $ 1,000 x ($ 5,000 divided by $ 10,000)).

**(5)**Production cost allocation ratio.

**(i)**Producers may use the production cost allocation ratio, computed as follows:

Section 263A [26 USCS § 263A] production costs

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Total costs

**(ii)**Section 263A [26 USCS § 263A] production costs are defined as the total costs (excluding mixed service costs and interest) allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities) under section 263A [26 USCS § 263A] that are incurred in the taxpayer's trade or business during the taxable year. Total costs are defined as all costs (excluding mixed service costs and interest) incurred in the taxpayer's trade or business during the taxable year. Total costs include all direct and indirect costs allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities) as well as all other costs of the taxpayer's trade or business, including, but not limited to: salaries and other labor costs of all personnel; all depreciation taken for federal income tax purposes; research and experimental expenditures; and selling, marketing, and distribution costs. Such costs do not include, however, taxes described in paragraph (e)(3)(iii)(F) of this section. For example, taxpayer H, a producer, incurs $ 1,000 of total mixed service costs in the taxable year. H's section 263A [26 USCS § 263A] production costs are $ 10,000 and its total costs are $ 20,000. Under the production cost allocation ratio, H's capitalizable mixed service costs are $ 500 (i.e., $ 1,000 X ($ 10,000 divided by $ 20,000)).

**(6)**Definition of total mixed service costs. Total mixed service costs are defined as the total costs incurred during the taxable year in all departments or functions of the taxpayer's trade or business that perform mixed service activities. See paragraph (e)(4)(ii)(C) of this section which defines mixed service costs. In determining the total mixed service costs of a trade or business, the taxpayer must include all costs incurred in its mixed service departments and cannot exclude any otherwise deductible service costs. For example, if the accounting department within a trade or business is a mixed service department, then in determining the total mixed service costs of the trade or business, the taxpayer cannot exclude the costs of personnel in the accounting department that perform services relating to non-production activities (e.g., accounts receivable or customer billing activities). Instead, the entire cost of the accounting department must be included in the total mixed service costs.

**(7)**Costs allocable to more than one business. To the extent mixed service costs, labor costs, or other costs are incurred in more than one trade or business, the taxpayer must determine the amounts allocable to the particular trade or business for which the simplified service cost method is being applied by using any reasonable allocation method consistent with the principles of paragraph (f)(4) of this section.

**(8)**De minimis rule. If the taxpayer elects to apply the de minimis rule of paragraph (g)(4)(ii) of this section to any mixed service department, the department is not considered a mixed service department for purposes of the simplified service cost method. Instead, the costs of such department are allocated exclusively to the particular activity satisfying the 90-percent test.

**(9)**Separate election. A taxpayer may elect the simplified service cost method in conjunction with any other allocation method used at the trade or business level, including the simplified methods described in §§

1.263A-2(b) and 1.263A-3(d). However, the election of the simplified service cost method must be made independently of the election to use those other simplified methods.

**(i)**[Reserved]

**(j)**Special rules --

**(1)**Costs provided by a related person --

**(i)**In general. A taxpayer subject to section 263A [26 USCS § 263A] must capitalize an arm's-length charge for any section 263A [26 USCS § 263A] costs (e.g., costs of materials, labor, or services) incurred by a related person that are properly allocable to the property produced or property acquired for resale by the taxpayer. Both the taxpayer and the related person must account for the transaction as if an arm's-length charge had been incurred by the taxpayer with respect to its property produced or property acquired for resale. For purposes of this paragraph (j)(1)(i), a taxpayer is considered related to another person if the taxpayer and such person are described in section 482 [26 USCS § 482]. Further, for purposes of this paragraph (j)(1)(i), arm's-length charge means the arm's-length charge (or other appropriate charge where permitted and applicable) under the principles of section 482 [26 USCS § 482]. Any correlative adjustments necessary because of the arm's-length charge requirement of this paragraph (j)(1)(i) shall be determined under the principles of section 482 [26 USCS § 482].

**(ii)**Exceptions. The provisions of paragraph (j)(1)(i) of this section do not apply if, and to the extent that --

**(A)**It would be inappropriate under the principles of section 482 [26 USCS § 482] for the Commissioner to adjust the income of the taxpayer or the related person with respect to the transaction at issue; or

**(B)**A transaction is accounted for under an alternative Internal Revenue Code section resulting in the capitalization (or deferral of the deduction) of the costs of the items provided by the related party and the related party does not deduct such costs earlier than the costs would have been deducted by the taxpayer if the costs were capitalized under section 263A [26 USCS § 263A]. See § 1.1502-13.

**(2)**Optional capitalization of period costs --

**(i)**In general. Taxpayers are not required to capitalize indirect costs that do not directly benefit or are not incurred by reason of the production of property or acquisition of property for resale (i.e., period costs). A taxpayer may, however, elect to capitalize certain period costs if: The method is consistently applied; is used incomputing beginning inventories, ending inventories, and cost of goods sold; and does not result in a material distortion of the taxpayer's income. A material distortion relates to the source, character, amount, or timing of the cost capitalized or any other item affected by the capitalization of the cost. Thus, for example, a taxpayer may not capitalize a period cost under section 263A [26 USCS § 263A] if capitalization would result in a material change in the computation of the foreign tax credit limitation under section 904 [26 USCS § 904]. An election to capitalize a period cost is the adoption of (or a change in) a method of accounting under section 446 of the Internal Revenue Code [26 USCS § 446].

**(ii)**Period costs eligible for capitalization. The types of period costs eligible for capitalization under this paragraph (j)(2) include only the types of period costs (e.g., under paragraph (e)(3)(iii) of this section) for which some portion of the costs incurred is properly allocable to property produced or property acquired for resale in the year of the election. Thus, for example, marketing or advertising costs, no portion of which are properly allocable to property produced or property acquired for resale, do not qualify for elective capitalization under this paragraph (j)(2).

**(3)**Trade or business application. Notwithstanding the references generally to taxpayer throughout this section and §§ 1.263A-2 and 1.263A-3, the methods of accounting provided under section 263A [26 USCS § 263A] are to be elected and applied independently for each separate and distinct trade or business of the taxpayer in accordance with the provisions of section 446(d) [26 USCS § 446(d)] and the regulations thereunder.

**(4)**Transfers with a principal purpose of tax avoidance. The District Director may require appropriate adjustments to valuations of inventory and other property subject to section 263A [26 USCS § 263A] if a transfer of property is made to another person for a principal purpose of avoiding the application of section 263A [26 USCS § 263A]. Thus, for example, the District Director may require a taxpayer using the simplified production method of § 1.263A-2(b) to apply that method to transferred inventories immediately prior to a transfer under section 351 [26 USCS § 351] if a principal purpose of the transfer is to avoid the application of section 263A [26 USCS § 263A].

**(k)**Change in method of accounting --

**(1)**In general. A change in a taxpayer's treatment of mixed service costs to comply with paragraph (h)(2)(i)(D) of this section is a change in method of accounting to which the provisions of sections 446 and 481 [26 USCS §§ 446 and 481] and the regulations under those sections apply. See § 1.263A-7. For a taxpayer's first taxable year ending on or after August 2, 2005, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with paragraph (h)(2)(i)(D) of this section, provided the taxpayer follows the administrative procedures, as modified by paragraphs (k)(2) through (4) of this section, issued under § 1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002-9 (2002-1 CB 327), as modified and clarified by Announcement 2002-17 (2002-1 CB 561), modified and amplified by Rev. Proc. 2002-19 (2002-1 CB 696), and amplified, clarified, and modified by Rev. Proc. 2002-54 (2002-2 CB 432), and § 601.601(d)(2)(ii)(b) of this chapter). For purposes of Form 3115, "Application for Change in Accounting Method," the designated number for the automatic accounting method change authorized by this paragraph (k) is "95." If Form 3115 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form. Alternatively, notwithstanding the provisions of any administrative procedures that preclude a taxpayer from requesting the advance consent of the Commissioner to change a method of accounting that is required to be made pursuant to a published automatic change procedure, for its first taxable year ending on or after August 2, 2005, a taxpayer may request the advance consent of the Commissioner to change its method of accounting to comply with paragraph (h)(2)(i)(D) of this section, provided the taxpayer follows the administrative procedures, as modified by paragraphs (k)(2) through (5) of this section, for obtaining the advance consent of the Commissioner (for further guidance, for example, see Rev. Proc. 97-27 (1997-1 CB 680), as modified and amplified by Rev. Proc. 2002-19 (2002-1 CB 696), as amplified and clarified by Rev. Proc. 2002-54 (2002-2 CB 432), and § 601.601(d)(2)(ii)(b) of this chapter). For the taxpayer's second and subsequent taxable years ending on or after August 2, 2005, requests to secure the consent of the Commissioner must be made under the administrative procedures, as modified by paragraphs (k)(3) and (4) of this section, for obtaining the Commissioner's advance consent to a change in accounting method.

**(2)**Scope limitations. Any limitations on obtaining the automatic consent or advance consent of the Commissioner do not apply to a taxpayer seeking to change its method of accounting to comply with paragraph (h)(2)(i)(D) of this section for its first taxable year ending on or after August 2, 2005.

**(3)**Audit protection. A taxpayer that changes its method of accounting in accordance with this paragraph (k) to comply with paragraph (h)(2)(i)(D) of this section does not receive audit protection if its method of accounting for mixed service costs is an issue under consideration at the time the application is filed with the national office.

**(4)**Section 481(a) [26 USCS § 481(a)] adjustment. A change in method of accounting to conform to paragraph (h)(2)(i)(D) of this section requires a section 481(a) [26 USCS § 481(a)] adjustment. The section 481(a) [26 USCS § 481(a)] adjustment period is two taxable years for a net positive adjustment for an accounting method change that is made to conform to paragraph (h)(2)(i)(D) of this section.

**(5)**Time for requesting change. Notwithstanding the provisions of § 1.446-1(e)(3)(i) and any contrary administrative procedure, a taxpayer may submit a request for advance consent to change its method of accounting to comply with paragraph (h)(2)(i)(D) of this section for its first taxable year ending on or after

August 2, 2005, on or before the date that is 30 days after the end of the taxable year for which the change is requested.

**(l)**Effective/applicability date --

**(1)**In general. Except as provided in (l)(2), (l)(3), and (l)(4) of this section, the effective dates for this section are provided in paragraph (a)(2) of this section.

**(2)**Mixed service costs; self-constructed tangible personal property produced on a routine and repetitive basis. Paragraphs (h)(2)(i)(D), (k), and (l)(2) of this section apply for taxable years ending on or after August 2, 2005.

**(3)**Costs allocable to property sold; indirect costs; licensing and franchise costs. Paragraphs (c)(5), (e)(3)(i), and (e)(3)(ii)(U) of this section apply for taxable years ending on or after January 13, 2014.

**(4)**Materials and supplies --

**(i)**In general. The last sentence of paragraphs (e)(2)(i)(A) and (e)(3)(ii)(E) of this section, and paragraph (l)(4) of this section apply to amounts paid (to acquire or produce property) in taxable years beginning on or after January 1, 2014.

**(ii)**Early application of this section. A taxpayer may choose to apply the last sentence of paragraphs (e)(2)(i)(A) and (e)(3)(ii)(E) of this section, and paragraph (l)(4) of this section to amounts paid (to acquire or produce property) in taxable years beginning on or after January 1, 2012.

**(iii)**Optional application of TD 9564. A taxpayer may choose to apply § 1.263A-1T(b)(14), the introductory phrase of § 1.263A-1T(c)(4), the last sentence of § 1.263A-1T(e)(2)(i)(A), the last sentence of § 1.263A-1T(e)(3)(ii)(E), § 1.263A-1T(l), and § 1.263A-1T(m)(2), as these provisions are contained in TD 9564 (76 FR 81060) December 27, 2011, to amounts paid (to acquire or produce property) in taxable years beginning on or after January 1, 2012, and before January 1, 2014.

## Statutory Authority

**AUTHORITY NOTE APPLICABLE TO ENTIRE PART:**
26 U.S.C. 7805.

## History

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# 26 CFR 1.446-1

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## § 1.446-1 General rule for methods of accounting.

**(a) General rule.**

**(1)**Section 446(a) [26 USCS § 446(a)] provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) [26 USCS § 446(e)] and paragraph (e) of this section.

**(2)**It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

**(3)**Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461 [26 USCS §§ 451 and 461], and the regulations thereunder.

**(4)**Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 [26 USCS § 6001] and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

**(i)**In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see section 263A, 471, and 472 [26 USCS § 263A, 471, and 472] and the regulations thereunder.)

**(ii)**Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

**(iii)**In any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, or depletion, any expenditures (other than ordinary repairs) made to restore the asset or prolong its useful life shall be added to the asset account or charged against the appropriate reserve.

**(b) Exceptions.**

**(1)**If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

**(2)**A taxpayer whose sole source of income is wages need not keep formal books in order to have an accounting method. Tax returns, copies thereof, or other records may be sufficient to establish the use of the method of accounting used in the preparation of the taxpayer's income tax returns.

**(c)**Permissible methods -- (1) In general. Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

**(i)**Cash receipts and disbursements method. Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451-2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) [26 USCS § 461(a)] and paragraph (a)(1) of § 1.461-1.

**(ii)**Accrual method. (A) Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of § 1.461-1 for examples of liabilities that may not be taken into account until after the taxable year incurred, and see §§ 1.461-4 through 1.461-6 for rules relating to economic performance.) Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 [26 USCS § 162] provides that a deductible liability generally is taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A [26 USCS § 263 or 263A], a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of § 1.263A-1(c)(3)) and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and related guidance.

**(B)**The term "liability" includes any item allowable as a deduction, cost, or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. Thus, for example, an amount that a taxpayer expends or will expend for capital improvements to property must be incurred before the taxpayer may take the amount into account in computing its basis in the property. The term "liability" is not limited to items for which a legal obligation to pay exists at the time of payment. Thus, for example, amounts prepaid for goods or services and amounts paid without a legal obligation to do so may not be taken into account by an accrual basis taxpayer any earlier than the taxable year in which those amounts are incurred.

**(C)**No method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. For example, a taxpayer engaged in a manufacturing business may account for sales of the taxpayer's product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customers, whether or not billed, depending on the method regularly employed in keeping the taxpayer's books.

**(iii)**Other permissible methods. Special methods of accounting are described elsewhere in chapter 1 of the Code and the regulations thereunder. For example, see the following sections and the regulations thereunder: Sections 61 and 162 [26 USCS §§ 61 and 162], relating to the crop method of accounting; section 453 [26 USCS § 453], relating to the installment method; section 460 [26 USCS § 460], relating to the long-term contract methods. In addition, special methods of accounting for particular items of income and expense are provided under other sections of chapter 1. For example, see section 174 [26 USCS § 174], relating to research and experimental expenditures, and section 175 [26 USCS § 175], relating to soil and water conservation expenditures.

**(iv)**Combinations of the foregoing methods. (a) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

**(b)**A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

**(2) Special rules.**

**(i)**In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

**(ii)**No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the regulations in this part if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. See section 446(a) [26 USCS § 446(a)] and paragraph (a) of this section, which require that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books, and section 446(e) [26 USCS § 446(e)] and paragraph (e) of this section, which require the prior approval of the Commissioner in the case of changes in accounting method.

**(iii)**The timing rules of § 1.1502-13 are a method of accounting for intercompany transactions (as defined in § 1.1502-13(b)(1)(i)), to be applied by each member of a consolidated group in addition to the member's other methods of accounting. See § 1.1502-13(a)(3)(i). This paragraph (c)(2)(iii) is applicable to consolidated return years beginning on or after November 7, 2001.

**(d) Taxpayer engaged in more than one business.**

**(1)**Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

**(2)**No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

**(3)**If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

**(e) Requirement respecting the adoption or change of accounting method.**

**(1)**A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) [26 USCS § 446(c)] and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) [26 USCS § 446(d)] and paragraph (d) of this section. See also section 446(a) [26 USCS § 446(a)] and paragraph (a) of this section.

**(2)**

**(i)**Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

**(ii)**

**(a)**A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 [26 USCS §§ 471 and 472] and the regulations under sections 471 and 472 [26 USCS §§ 471 and 472]), a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.460-4), certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations under the Internal Revenue Code specifically require that the consent of the Commissioner must be obtained before adopting such a change.

**(b)**A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and of items that are deducted as business expenses, but that are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts. Although such adjustment may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustment in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve (for example, for banks under section 585 of the Internal Revenue Code [26 USCS § 585]), see the regulations under section 166 of the Internal Revenue Code [26 USCS § 166]. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. For further guidance on changes involving depreciable or amortizable assets, see paragraph (e)(2)(ii)(d) of this section and § 1.1016-3(h).

**(c)**A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting.

**(d) Changes involving depreciable or amortizable assets --**

**(1)**Scope. This paragraph (e)(2)(ii)(d) applies to property subject to section 167, 168, 197, 1400I, 1400L(c) [26 USCS § 167, 168, 197, 1400I, 1400L(c)], to section 168 [26 USCS § 168] prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168 [26 USCS § 168]), or to an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d) [26 USCS § 168(k), 1400L(b), or 1400N(d)]).

**(2)**Changes in depreciation or amortization that are a change in method of accounting. Except as provided in paragraph (e)(2)(ii)(d)(3) of this section, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or vice versa, is a change in method of accounting. Additionally, a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting. Further, except as provided in paragraph (e)(2)(ii)(d)(3) of this section, the following changes in computing depreciation or amortization are a change in method of accounting:

**(i)**A change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset.

**(ii)**A change from not claiming to claiming the additional first year depreciation deduction provided by, for example, section 168(k), 1400L(b), or 1400N(d) [26 USCS § 168(k), 1400L(b), or 1400N(d)], for, and the resulting change to the amount otherwise allowable as a depreciation deduction for the remaining adjusted depreciable basis (or similar basis) of, depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property), provided the taxpayer did not make the election out of the additional first year depreciation deduction (or did not make a deemed election out of the additional first year depreciation deduction; for further guidance, for example, see Rev. Proc. 2002-33 (2002-1 C.B. 963), Rev. Proc. 2003-50 (2003-2 C.B. 119), Notice 2006-77 (2006-40 I.R.B. 590), and § 601.601(d)(2)(ii)(b) of this chapter) for the class of property in which the depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property) is included.

**(iii)**A change from claiming the 30-percent additional first year depreciation deduction to claiming the 50-percent additional first year depreciation deduction for depreciable property that qualifies for the 50-percent additional first year depreciation deduction, provided the property is not included in any class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction (for example, 50-percent bonus depreciation property or qualified Gulf Opportunity Zone property), or a change from claiming the 50-percent additional first year depreciation deduction to claiming the 30-percent additional first year depreciation deduction for depreciable property that qualifies for the 30-percent additional first year depreciation deduction, including property that is included in a class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction (for example, qualified property or qualified New York Liberty Zone property), and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's remaining adjusted depreciable basis (or similar basis). This paragraph (e)(2)(ii)(d)(2)(iii) does not apply if a taxpayer is making a late election or revoking a timely valid election under the applicable additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d) [26 USCS § 168(k), 1400L(b), or 1400N(d)]) (see paragraph (e)(2)(ii)(d)(3)(iii) of this section).

**(iv)**A change from claiming to not claiming the additional first year depreciation deduction for an asset that does not qualify for the additional first year depreciation deduction, including an asset that is included in a class of property for which the taxpayer elected not to claim any additional first year depreciation deduction (for example, an asset that is not qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property), and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's depreciable basis.

**(v)**A change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by the Internal Revenue Code (for example, section 168(b)(4) [26 USCS § 168(b)(4)]), the regulations under the Internal Revenue Code (for example, § 1.197-2(f)(1)(ii)), or other guidance published in the Internal Revenue Bulletin.

**(vi)**A change in the accounting for depreciable or amortizable assets from a single asset account to a multiple asset account (pooling), or vice versa, or from one type of multiple asset account (pooling) to a different type of multiple asset account (pooling).

**(vii)**For depreciable or amortizable assets that are mass assets accounted for in multiple asset accounts or pools, a change in the method of identifying which assets have been disposed. For purposes of this paragraph (e)(2)(ii)(d)(2)(vii), the term mass assets means a mass or group of individual items of depreciable or amortizable assets that are not necessarily homogeneous, each of which is minor in value relative to the total value of the mass or group, numerous in quantity, usually accounted for only on a total dollar or quantity basis, with respect to which separate identification is impracticable, and placed in service in the same taxable year.

**(viii)**Any other change in depreciation or amortization as the Secretary may designate by publication in the Federal Register or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

**(3)**Changes in depreciation or amortization that are not a change in method of accounting. Section 1.446-1(e)(2)(ii)(b) applies to determine whether a change in depreciation or amortization is not a change in method of accounting. Further, the following changes in depreciation or amortization are not a change in method of accounting:

**(i)**Useful life. An adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 [26 USCS § 167] (other than under section 168 [26 USCS § 168], section 1400I [26 USCS § 1400I], section 1400L(c) [26

USCS § 1400L(c)], former section 168 [26 USCS § 168], or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d) [26 USCS § 168(k), 1400L(b), or 1400N(d)])) is not a change in method of accounting. This paragraph (e)(2)(ii)(d)(3)(i) does not apply if a taxpayer is changing to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Internal Revenue Code (for example, section 167(f)(1) [26 USCS § 167(f)(1)], section 168(c) [26 USCS § 168(c)], section 168(g)(2) or (3) [26 USCS § 168(g)(2) or (3)], section 197 [26 USCS § 197]), the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin and, therefore, such change is a change in method of accounting (unless paragraph (e)(2)(ii)(d)(3)(v) of this section applies). See paragraph (e)(2)(ii)(d)(5)(iv) of this section for determining the taxable year in which to correct an adjustment in useful life that is not a change in method of accounting.

**(ii)**Change in use. A change in computing depreciation or amortization allowances in the taxable year in which the use of an asset changes in the hands of the same taxpayer is not a change in method of accounting.

**(iii)**Elections. Generally, the making of a late depreciation or amortization election or the revocation of a timely valid depreciation or amortization election is not a change in method of accounting, except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin. This paragraph (e)(2)(ii)(d)(3)(iii) also applies to making a late election or revoking a timely valid election made under section 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (107 Stat. 312, 540) (relating to amortizable section 197 [26 USCS § 197] intangibles). A taxpayer may request consent to make a late election or revoke a timely valid election by submitting a request for a private letter ruling. For making or revoking an election under section 179 of the Internal Revenue Code [26 USCS § 179], see section 179(c) [26 USCS § 179(c)] and § 1.179-5.

**(iv)**Salvage value. Except as provided under paragraph (e)(2)(ii)(d)(2)(v) of this section, a change in salvage value of a depreciable or amortizable asset is not treated as a change in method of accounting.

**(v)**Placed-in-service date. Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin, any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting. For example, if a taxpayer changes the placed-in-service date of a depreciable or amortizable asset because the taxpayer incorrectly determined the date on which the asset was placed in service, such a change is a change in the placed-in-service date of the asset and, therefore, is not a change in method of accounting. However, if a taxpayer incorrectly determines that a depreciable or amortizable asset is nondepreciable property and later changes the treatment of the asset to depreciable property, such a change is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting under paragraph (e)(2)(ii)(d)(2) of this section. Further, a change in the convention of a depreciable or amortizable asset is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting under paragraph (e)(2)(ii)(d)(2)(i) of this section. See paragraph (e)(2)(ii)(d)(5)(v) of this section for determining the taxable year in which to make a change in the placed-in-service date of a depreciable or amortizable asset that is not a change in method of accounting.

**(vi)**Any other change in depreciation or amortization as the Secretary may designate by publication in the Federal Register or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

**(4)**Item being changed. For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(d) applies, the item being changed generally is the depreciation treatment of each individual depreciable or amortizable asset. However, the item is the depreciation treatment of each vintage account with respect to a depreciable asset for which depreciation is determined under § 1.167(a)-11 (class life asset depreciation range (CLADR) property). Similarly, the item is the depreciable treatment of each general asset account with respect to a depreciable asset for which general asset account treatment has been elected under section 168(i)(4) [26 USCS § 168(i)(4)] or the item is the depreciation treatment of each mass asset account with respect to a depreciable asset for which mass asset account treatment has been elected under former section 168(d)(2)(A) [26 USCS § 168(d)(2)(A)]. Further, a change in computing depreciation or amortization under section 167 [26 USCS § 167] (other than under section 168 [26 USCS § 168], section 1400I [26 USCS § 1400I], section 1400L(c) [26 USCS § 1400L(c)], former section 168 [26 USCS § 168], or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d) [26 USCS § 168(k), 1400L(b), or 1400N(d)])) is permitted only with respect to all assets in a particular account (as defined in § 1.167(a)-7) or vintage account.

**(5)**Special rules. For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(d) applies --

**(i)**Declining balance method to the straight line method for MACRS property. For tangible, depreciable property subject to section 168 [26 USCS § 168] (MACRS property) that is depreciated using the 200-percent or 150-percent declining balance method of depreciation under section 168(b)(1) or (2) [26 USCS § 168(b)(1) or (2)], a taxpayer may change without the consent of the Commissioner from the declining balance method of depreciation to the straight line method of depreciation in the first taxable year in which the use of the straight line method with respect to the adjusted depreciable basis of the MACRS property as of the beginning of that year will yield a depreciation allowance that is greater than the depreciation allowance yielded by the use of the declining balance method. When the change is made, the adjusted depreciable basis of the MACRS property as of the beginning of the taxable year is recovered through annual depreciation allowances over the remaining recovery period (for further guidance, see section 6.06 of Rev. Proc. -57 (1987-2 C.B. 687) and § 601.601(d)(2)(ii)(b) of this chapter).

**(ii)**Depreciation method changes for section 167 [26 USCS § 167] property. For a depreciable or amortizable asset for which depreciation is determined under section 167 [26 USCS § 167] (other than under section 168 [26 USCS § 168], section 1400I [26 USCS § 1400I], section 1400L(c) [26 USCS § 1400L(c)], former section 168 [26 USCS § 168], or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d) [26 USCS § 168(k), 1400L(b), or 1400N(d)])), see § 1.167(e)-1(b), (c), and (d) for the changes in depreciation method that are permitted to be made without the consent of the Commissioner. For CLADR property, see § 1.167(a)-11(c)(1)(iii) for the changes in depreciation method for CLADR property that are permitted to be made without the consent of the Commissioner. Further, see § 1.167(a)-11(b)(4)(iii)(c) for how to correct an incorrect classification or characterization of CLADR property.

**(iii)**Section 481 [26 USCS § 481] adjustment. Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin, no section 481 [26 USCS § 481] adjustment is required or permitted for a change from one permissible method of computing depreciation or amortization to another permissible method of computing depreciation or amortization for an asset because this change is implemented by either a cut-off method (for further guidance, for example, see section 2.06 of Rev. Proc. 97-27 (1997-1 C.B. 680), section 2.06 of Rev. Proc. 2002-9 (2002-1 C.B. 327), and §

601.601(d)(2)(ii)(b) of this chapter) or a modified cut-off method (under which the adjusted depreciable basis of the asset as of the beginning of the year of change is recovered using the new permissible method of accounting), as appropriate. However, a change from an impermissible method of computing depreciation or amortization to a permissible method of computing depreciation or amortization for an asset results in a section 481 [26 USCS § 481] adjustment. Similarly, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable (or vice versa) or a change in the treatment of an asset from expensing to depreciating (or vice versa) results in a section 481 [26 USCS § 481] adjustment.

**(iv)**Change in useful life. This paragraph (e)(2)(ii)(d)(5)(iv) applies to an adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 [26 USCS § 167] (other than under section 168 [26 USCS § 168], section 1400I [26 USCS § 1400I], section 1400L(c) [26 USCS § 1400L(c)], former section 168 [26 USCS § 168], or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d) [26 USCS § 168(k), 1400L(b), or 1400N(d)])) and that is not a change in method of accounting under paragraph (e)(2)(ii)(d) of this section. For this adjustment in useful life, no section 481 [26 USCS § 481] adjustment is required or permitted. The adjustment in useful life, whether initiated by the Internal Revenue Service (IRS) or a taxpayer, is corrected by adjustments in the taxable year in which the conditions known to exist at the end of that taxable year changed thereby resulting in a redetermination of the useful life under § 1.167(a)-1(b) (or if the period of limitation for assessment under section 6501(a) [26 USCS § 6501(a)] has expired for that taxable year, in the first succeeding taxable year open under the period of limitation for assessment), and in subsequent taxable years. In other situations (for example, the useful life is incorrectly determined in the placed-in-service year), the adjustment in the useful life, whether initiated by the IRS or a taxpayer, may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) [26 USCS § 6501(a)] or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the correction in useful life, in lieu of filing amended Federal tax returns (for example, because the conditions known to exist at the end of a prior taxable year changed thereby resulting in a redetermination of the useful life under § 1.167(a)-1(b)), the taxpayer may correct the adjustment in useful life by adjustments in the current and subsequent taxable years.

**(v)**Change in placed-in-service date. This paragraph (e)(2)(ii)(d)(5)(v) applies to a change in the placed-in-service date of a depreciable or amortizable asset that is not a change in method of accounting under paragraph (e)(2)(ii)(d) of this section. For this change in placed-in-service date, no section 481 [26 USCS § 481] adjustment is required or permitted. The change in placed-in-service date, whether initiated by the IRS or a taxpayer, may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) [26 USCS § 6501(a)] or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the change in placed-in-service date, in lieu of filing amended Federal tax returns, the taxpayer may correct the placed-in-service date by adjustments in the current and subsequent taxable years.

**(iii)**Examples. The rules of this paragraph (e) are illustrated by the following examples:

Example 1. Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example 2. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example 3. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example 4. From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Example 5. A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change in method of accounting for inventories.

Example 6. A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations under the Internal Revenue Code. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example 7. A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a "reserve for price changes." Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations under the Internal Revenue Code, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example 8. A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

Example 9. In 2003, A1, a calendar year taxpayer engaged in the trade or business of manufacturing knitted goods, purchased and placed in service a building and its components at a total cost of $

10,000,000 for use in its manufacturing operations. A1 classified the $ 10,000,000 as nonresidential real property under section 168(e) [26 USCS § 168(e)]. A1 elected not to deduct the additional first year depreciation provided by section 168(k) [26 USCS § 168(k)] on its 2003 Federal tax return. As a result, on its 2003, 2004, and 2005 Federal tax returns, A1 depreciated the $ 10,000,000 under the general depreciation system of section 168(a) [26 USCS § 168(a)], using the straight line method of depreciation, a 39-year recovery period, and the mid-month convention. In 2006, A1 completes a cost segregation study on the building and its components and identifies items that cost a total of $ 1,500,000 as section 1245 [26 USCS § 1245] property. As a result, the $ 1,500,000 should have been classified in 2003 as 5-year property under section 168(e) [26 USCS § 168(e)] and depreciated on A1's 2003, 2004, and 2005 Federal tax returns under the general depreciation system, using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, A1's change to this depreciation method, recovery period, and convention is a change in method of accounting. This method change results in a section 481 [26 USCS § 481] adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the assets are depreciated under section 168 [26 USCS § 168].

Example 10. In 2003, B, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $ 1,000,000 for use in its plant located outside the United States. The equipment is 15-year property under section 168(e) [26 USCS § 168(e)] with a class life of 20 years. The equipment is required to be depreciated under the alternative depreciation system of section 168(g) [26 USCS § 168(g)]. However, B incorrectly depreciated the equipment under the general depreciation system of section 168(a) [26 USCS § 168(a)], using the 150-percent declining balance method, a 15-year recovery period, and the half-year convention. In 2010, the IRS examines B's 2007 Federal income tax return and changes the depreciation of the equipment to the alternative depreciation system, using the straight line method of depreciation, a 20-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, this change in depreciation method and recovery period made by the IRS is a change in method of accounting. This method change results in a section 481 [26 USCS § 481] adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the assets are depreciated under section 168 [26 USCS § 168].

Example 11. In May 2003, C, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. C never held this equipment for sale. However, C incorrectly treated the equipment as inventory on its 2003 and 2004 Federal tax returns. In 2005, C realizes that the equipment should have been treated as a depreciable asset. Pursuant to paragraph (e)(2)(ii)(d)(2) of this section, C's change in the treatment of the equipment from inventory to a depreciable asset is a change in method of accounting. This method change results in a section 481 [26 USCS § 481] adjustment.

Example 12. Since 2003, D, a calendar year taxpayer, has used the distribution fee period method to amortize distributor commissions and, under that method, established pools to account for the distributor commissions (for further guidance, see Rev. Proc. 2000-38 (2000-2 C.B. 310) and § 601.601(d)(2)(ii)(b) of this chapter). A change in the accounting of distributor commissions under the distribution fee period method from pooling to single asset accounting is a change in method of accounting pursuant to paragraph (e)(2)(ii)(d)(2)(vi) of this section. This method change results in no section 481 [26 USCS § 481] adjustment because the change is from one permissible method to another permissible method.

Example 13. Since 2003, E, a calendar year taxpayer, has accounted for items of MACRS property that are mass assets in pools. Each pool includes only the mass assets that are placed in service by E in the same taxable year. E is able to identify the cost basis of each asset in each pool. None of the pools are general asset accounts under section 168(i)(4) [26 USCS § 168(i)(4)] and the regulations under section 168(i)(4) [26 USCS § 168(i)(4)]. E identified any dispositions of these mass assets by specific identification. Because of changes in E's recordkeeping in 2006, it is impracticable for E to continue to identify disposed mass assets using specific identification. As a result, E wants to change to a first-in, first-out method under which the mass assets disposed of in a taxable year are deemed to be from the pool with the earliest placed-in-service year in existence as of the beginning of the taxable year of each disposition. Pursuant to paragraph (e)(2)(ii)(d)(2)(vii) of this section, this change is a change in method of accounting. This method change results in no section 481 [26 USCS § 481] adjustment because the change is from one permissible method to another permissible method.

Example 14. In August 2003, F, a calendar year taxpayer, purchased and placed in service a copier for use in its trade or business. F incorrectly classified the copier as 7-year property under section 168(e) [26 USCS § 168(e)]. F elected not to deduct the additional first year depreciation provided by section 168(k) [26 USCS § 168(k)] on its 2003 Federal tax return. As a result, on its 2003 and 2004 Federal tax returns, F depreciated the copier under the general depreciation system of section 168(a) [26 USCS § 168(a)], using the 200-percent declining balance method of depreciation, a 7-year recovery period, and the half-year convention. In 2005, F realizes that the copier is 5-year property and should have been depreciated on its 2003 and 2004 Federal tax returns under the general depreciation system using a 5-year recovery period rather than a 7-year recovery period. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, F's change in recovery period from 7 to 5 years is a change in method of accounting. This method change results in a section 481 [26 USCS § 481] adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the copier is depreciated under section 168 [26 USCS § 168].

Example 15. In 2004, G, a calendar year taxpayer, purchased and placed in service an intangible asset that is not an amortizable section 197 [26 USCS § 197] intangible and that is not described in section 167(f) [26 USCS § 167(f)]. G amortized the cost of the intangible asset under section 167(a) [26 USCS § 167(a)] using the straight line method of depreciation and a determinable useful life of 13 years. The safe harbor useful life of 15 or 25 years under § 1.167(a)-3(b) does not apply to the intangible asset. In 2008, because of changing conditions, G changes the remaining useful life of the intangible asset to 2 years. Pursuant to paragraph (e)(2)(ii)(d)(3)(i) of this section, G's change in useful life is not a change in method of accounting because the intangible asset is depreciated under section 167 [26 USCS § 167] and G is not changing to or from a useful life that is specifically assigned by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin.

Example 16. In July 2003, H, a calendar year taxpayer, purchased and placed in service "off-the-shelf" computer software and a new computer. The cost of the new computer and computer software are separately stated. H incorrectly included the cost of this software as part of the cost of the computer, which is 5-year property under section 168(e) [26 USCS § 168(e)]. On its 2003 Federal tax return, H elected to depreciate its 5-year property placed in service in 2003 under the alternative depreciation system of section 168(g) [26 USCS § 168(g)] and H elected not to deduct the additional first year depreciation provided by section 168(k) [26 USCS § 168(k)]. The class life for a computer is 5 years. As a result, because H included the cost of the computer software as part of the cost of the computer hardware, H depreciated the cost of the software under the alternative depreciation system, using the straight line method of depreciation, a 5-year recovery period, and the half-year convention. In 2005, H realizes that the cost of the software should have been amortized under section 167(f)(1) [26 USCS § 167(f)(1)], using the straight line method of depreciation, a 36-month useful life, and a monthly convention. H's change from 5-years to 36-months is a change in method of accounting because H is changing to a useful life that is specifically assigned by section 167(f)(1) [26 USCS § 167(f)(1)]. The change in convention from the half-year to the monthly convention also is a change in method of accounting. Both changes result in a section 481 [26 USCS § 481] adjustment.

Example 17. On May 1, 2003, I2, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $ 500,000 for use in its business. The equipment is 5-year property under section 168(e) [26 USCS § 168(e)] with a class life of 9 years and is qualified property under section 168(k)(2) [26 USCS § 168(k)(2)]. I2 did not place in service any other depreciable property in 2003.

Section 168(g)(1)(A) through (D) [26 USCS § 168(g)(1)(A) -- (D)] do not apply to the equipment. I2 intended to elect the alternative depreciation system under section 168(g) [26 USCS § 168(g)] for 5-year property placed in service in 2003. However, I2 did not make the election. Instead, I2 deducted on its 2003 Federal tax return the 30-percent additional first year depreciation attributable to the equipment and, on its 2003 and 2004 Federal tax returns, depreciated the remaining adjusted depreciable basis of the equipment under the general depreciation system under 168(a), using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. In 2005, I2 realizes its failure to make the alternative depreciation system election in 2003 and files a Form 3115, "Application for Change in Accounting Method," to change its method of depreciating the remaining adjusted depreciable basis of the 2003 equipment to the alternative depreciation system. Because this equipment is not required to be depreciated under the alternative depreciation system, I2 is attempting to make an election under section 168(g)(7) [26 USCS § 168(g)(7)]. However, this election must be made in the taxable year in which the equipment is placed in service (2003) and, consequently, I2 is attempting to make a late election under section 168(g)(7) [26 USCS § 168(g)(7)]. Accordingly, I2's change to the alternative depreciation system is not a change in accounting method pursuant to paragraph (e)(2)(ii)(d)(3)(iii) of this section. Instead, I2 must submit a request for a private letter ruling under § 301.9100-3 of this chapter, requesting an extension of time to make the alternative depreciation system election on its 2003 Federal tax return.

Example 18. On December 1, 2004, J, a calendar year taxpayer, purchased and placed in service 20 previously-owned adding machines. For the 2004 taxable year, J incorrectly classified the adding machines as items in its "suspense" account for financial and tax accounting purposes. Assets in this suspense account are not depreciated until reclassified to a depreciable fixed asset account. In January 2006, J realizes that the cost of the adding machines is still in the suspense account and reclassifies such cost to the appropriate depreciable fixed asset account. As a result, on its 2004 and 2005 Federal tax returns, J did not depreciate the cost of the adding machines. Pursuant to paragraph (e)(2)(ii)(d)(2) of this section, J's change in the treatment of the adding machines from nondepreciable assets to depreciable assets is a change in method of accounting. The placed-in-service date exception under paragraph (e)(2)(ii)(d)(3)(v) of this section does not apply because the adding machines were incorrectly classified in a nondepreciable suspense account. This method change results in a section 481 [26 USCS § 481] adjustment.

Example 19. In December 2003, K, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. However, K did not receive the invoice for this equipment until January 2004. As a result, K classified the equipment on its fixed asset records as being placed in service in January 2004. On its 2004 and 2005 Federal tax returns, K depreciated the cost of the equipment. In 2006, K realizes that the equipment was actually placed in service during the 2003 taxable year and, therefore, depreciation should have began in the 2003 taxable year instead of the 2004 taxable year. Pursuant to paragraph (e)(2)(ii)(d)(3)(v) of this section, K's change in the placed-in-service date of the equipment is not a change in method of accounting.

**(3)**

**(i)**Except as otherwise provided under the authority of paragraph (e)(3)(ii) of this section, to secure the Commissioner's consent to a taxpayer's change in method of accounting the taxpayer generally must file an application on Form 3115, "Application for Change in Accounting Method," with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting. See §§ 1.381(c)(4)-1(d)(2) and 1.381(c)(5)-1(d)(2) for rules allowing additional time, in some circumstances, for the filing of an application on Form 3115 with respect to a transaction to which section 381(a) [26 USCS § 381(a)] applies. To the extent applicable, the taxpayer must furnish all information requested on the Form 3115. This information includes all classes of items that will be treated differently under the new method of accounting, any amounts that will be duplicated or omitted as a result of the proposed change, and the taxpayer's computation of any adjustments necessary to prevent such duplications or omissions. The Commissioner may require such other information as may be necessary to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer agrees to the Commissioner's prescribed terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary to prevent amounts from being duplicated or omitted is to be taken into account. See section 481 [26 USCS § 481] and the regulations thereunder, relating to certain adjustments resulting from accounting method changes, and section 472 [26 USCS § 472] and the regulations thereunder, relating to adjustments for changes to and from the last-in, first-out inventory method. For any Form 3115 filed on or after May 15, 1997, see §1.446-1T(e)(3)(i)(B).

**(ii)**Notwithstanding the provisions of paragraph (e)(3)(i) of this section, the Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted. The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or by an adjustment under section 481(a) [26 USCS § 481(a)] to be taken into account in the taxable year or years prescribed by the Commissioner.

**(iii)**This paragraph (e)(3) applies to Forms 3115 filed on or after December 31, 1997. For other Forms 3115, see §1.446-1(e)(3) in effect prior to December 31, 1997 (§1.446-1(e)(3) as contained in the 26 CFR part 1 edition revised as of April 1, 1997).

**(4) Effective date --**

**(i)**In general. Except as provided in paragraphs (e)(3)(iii), (e)(4)(ii), and (e)(4)(iii) of this section, paragraph (e) of this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see § 1.446-1(e) in effect prior to December 30, 2003 (§ 1.446-1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003).

**(ii)**Changes involving depreciable or amortizable assets. With respect to paragraph (e)(2)(ii)(d) of this section, paragraph (e)(2)(iii) Examples 9 through 19 of this section, and the language "certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section)" in the last sentence of paragraph (e)(2)(ii)(a) of this section --

**(A)**For any change in depreciation or amortization that is a change in method of accounting, this section applies to such a change in method of accounting made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003; and

**(B)**For any change in depreciation or amortization that is not a change in method of accounting, this section applies to such a change made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003.

**(iii)**Effective/applicability date for paragraph (e)(3)(i). The rules of paragraph (e)(3)(i) of this section apply to corporate reorganizations and tax-free liquidations described in section 381(a) [26 USCS § 381(a)] that occur on or after August 31, 2011.

## Statutory Authority

**AUTHORITY NOTE APPLICABLE TO ENTIRE PART:**
26 U.S.C. 7805.

## History

[25 FR 11708, Nov. 26, 1960, Treas. Dec. 6500, as amended by 35 FR 17710, Nov. 18, 1970, Treas. Dec. 7073; 38 FR 26184, Sept. 19, 1973, Treas. Dec. 7285; 51 FR 378, Jan. 6, 1986, Treas. Dec. 8067; 52 FR 10084, Mar. 30, 1987, Treas. Dec. 8131; 57 FR 12419, Apr. 10, 1992, Treas. Dec. 8408; 58 FR 42233, Aug. 9, 1993, Treas. Dec. 8482; 60 FR 40078, Aug. 7, 1995, Treas. Dec. 8608; 62 FR 26740, 26741, May 15, 1997, Treas. Dec. 8719; 62 FR

68167, 68169, Dec. 31, 1997, Treas. Dec. 8742; 66 FR 2219, 2223, Jan. 11, 2001, Treas. Dec. 8929; 67 FR 76985, Dec. 16, 2002, Treas. Dec. 9025; 69 FR 5, 8, Jan. 2, 2004, Treas. Dec. 9105; 71 FR 78066, 78068, Dec. 28, 2006, Treas. Dec. 9307; 76 FR 45673, 45688, Aug. 1, 2011, Treas. Dec. 9534]



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# 26 USCS § 174

Current through PL 114-218, approved 7/29/16

***United States Code Service - Titles 1 through 54 > TITLE 26. INTERNAL REVENUE CODE > SUBTITLE A. INCOME TAXES > CHAPTER 1. NORMAL TAXES AND SURTAXES > SUBCHAPTER B. COMPUTATION OF TAXABLE INCOME > PART VI. ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS***

## § 174. Research and experimental expenditures.

**(a)** Treatment as expenses.

**(1)** In general. A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

**(2)** When method may be adopted.

**(A)** Without consent. A taxpayer may, without the consent of the Secretary, adopt the method provided in this subsection for his first taxable year for which expenditures described in paragraph (1) are paid or incurred.

**(B)** With consent. A taxpayer may, with the consent of the Secretary, adopt at any time the method provided in this subsection.

**(3)** Scope. The method adopted under this subsection shall apply to all expenditures described in paragraph (1). The method adopted shall be adhered to in computing taxable income for the taxable year and for all subsequent taxable years unless, with the approval of the Secretary, a change to a different method is authorized with respect to part or all of such expenditures.

**(b)** Amortization of certain research and experimental expenditures.

**(1)** In general. At the election of the taxpayer, made in accordance with regulations prescribed by the Secretary, research or experimental expenditures which are--

**(A)** paid or incurred by the taxpayer in connection with his trade or business,

**(B)** not treated as expenses under subsection (a), and

**(C)** chargeable to capital account but not chargeable to property of a character which is subject to the allowance under section 167 [26 USCS § 167] (relating to allowance for depreciation, etc.) or section 611 [26 USCS § 611] (relating to allowance for depletion),may be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the taxpayer first realizes benefits from such expenditures). Such deferred expenses are expenditures properly chargeable to capital account for purposes of section 1016(a)(1) [26 USCS § 1016(a)(1)] (relating to adjustments to basis of property).

**(2)** Time for and scope of election. The election provided by paragraph (1) may be made for any taxable year, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The method so elected, and the period selected by the taxpayer, shall be adhered to in computing taxable income for the taxable year for which the election is made and for all subsequent taxable years unless, with the approval of the Secretary, a change to a different method (or to a different period) is authorized with respect to part or all of such expenditures. The election shall not apply to any expenditure paid or incurred during any taxable year before the taxable year for which the taxpayer makes the election.

**(c)** Land and other property. This section shall not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character which is subject to the allowance under section 167 [26 USCS § 167] (relating to allowance for depreciation, etc.) or section 611 [26 USCS § 611] (relating to allowance for depletion); but for purposes of this section allowances under section 167 [26 USCS § 167], and allowances under section 611 [26 USCS § 611], shall be considered as expenditures.

**(d)** Exploration expenditures. This section shall not apply to any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas).

**(e)** Only reasonable research expenditures eligible. This section shall apply to a research or experimental expenditure only to the extent that the amount thereof is reasonable under the circumstances.

**(f)** Cross References.

**(1)** For adjustments to basis of property for amounts allowed as deductions as deferred expenses under subsection (b), see section 1016(a)(14) [26 USCS § 1016(a)(14)].

**(2)** For election of 10-year amortization of expenditures allowable as a deduction under subsection (a), see section 59(e) [26 USCS § 59(e)].

## History

(Aug. 16, 1954, ch 736, 68A Stat. 66; Oct. 4, 1976,P.L. 94-455, Title XIX, §§ 1901(a)(30), 1906(b)(13)(A), 90 Stat. 1769, 1834; Sept. 3, 1982, P.L. 97-248, Title II, § 201(d)(9)(B), 96 Stat. 420; Jan. 12, 1983, P.L. 97-448, Title III, § 306(a)(1)(A)(i), 96 Stat. 2400; Oct. 22, 1986, P.L. 99-514, Title VII, § 701(e)(4)(D), 100 Stat. 2343; Nov. 10, 1988, P.L. 100-647, Title I, § 1007(g)(5), 102 Stat. 3435; Dec. 19, 1989, P.L. 101-239, Title VII, § 7110(d), 103 Stat. 2325.)

(As amended Dec. 19, 2014,P.L. 113-295, Div A, Title II, § 221(a)(31), (32), 128 Stat. 4042.)



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# 26 USCS § 197

Current through PL 114-218, approved 7/29/16

***United States Code Service - Titles 1 through 54 > TITLE 26. INTERNAL REVENUE CODE > SUBTITLE A. INCOME TAXES > CHAPTER 1. NORMAL TAXES AND SURTAXES > SUBCHAPTER B. COMPUTATION OF TAXABLE INCOME > PART VI. ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS***

## § 197. Amortization of goodwill and certain other intangibles.

**(a)** General rule. A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 [26 USCS § 197] intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.

**(b)** No other depreciation or amortization deduction allowable. Except as provided in subsection (a), no depreciation or amortization deduction shall be allowable with respect to any amortizable section 197 [26 USCS § 197] intangible.

**(c)** Amortizable section 197 [26 USCS § 197] intangible. For purposes of this section--

**(1)** In general. Except as otherwise provided in this section, the term "amortizable section 197 intangible" means any section 197 [26 USCS § 197] intangible--

**(A)** which is acquired by the taxpayer after the date of the enactment of this section, and

**(B)** which is held in connection with the conduct of a trade or business or an activity described in section 212 [26 USCS § 212].

**(2)** Exclusion of self-created intangibles, etc. The term "amortizable section 197 intangible" shall not include any section 197 intangible--

**(A)** which is not described in subparagraph (D), (E), or (F) of subsection (d)(1), and

**(B)** which is created by the taxpayer.This paragraph shall not apply if the intangible is created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

**(3)** Anti-churning rules.For exclusion of intangibles acquired in certain transactions, see subsection (f)(9).

**(d)** Section 197 intangible. For purposes of this section--

**(1)** In general. Except as otherwise provided in this section, the term "section 197 intangible" means--

**(A)** goodwill,

**(B)** going concern value,

**(C)** any of the following intangible items:

**(i)** workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,

**(ii)** business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),

**(iii)** any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,

**(iv)** any customer-based intangible,

**(v)** any supplier-based intangible, and

**(vi)** any other similar item,

**(D)** any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,

**(E)** any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and

**(F)** any franchise, trademark, or trade name.

**(2)** Customer-based intangible.

**(A)** In general. The term "customer-based intangible" means--

**(i)** composition of market,

**(ii)** market share, and

**(iii)** any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.

**(B)** Special rule for financial institutions. In the case of a financial institution, the term "customer-based intangible" includes deposit base and similar items.

**(3)** Supplier-based intangible. The term "supplier-based intangible" means any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.

**(e)** Exceptions. For purposes of this section, the term "section 197 intangible" shall not include any of the following:

**(1)** Financial interests. Any interest--

**(A)** in a corporation, partnership, trust, or estate, or

**(B)** under an existing futures contract, foreign currency contract, notional principal contract, or other similar financial contract.

**(2)** Land. Any interest in land.

**(3)** Computer software.

**(A)** In general. Any--

**(i)** computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified, and

**(ii)** other computer software which is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

**(B)** Computer software defined. For purposes of subparagraph (A), the term "computer software" means any program designed to cause a computer to perform a desired function. Such term shall not include any data base or similar item unless the data base or item is in the public domain and is incidental to the operation of otherwise qualifying computer software.

**(4)** Certain interests or rights acquired separately. Any of the following not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade business or substantial portion thereof:

**(A)** Any interest in a film, sound recording, video tape, book, or similar property.

**(B)** Any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof.

**(C)** Any interest in a patent or copyright.

**(D)** To the extent provided in regulations, any right under a contract (or granted by a governmental unit or an agency or instrumentality thereof) if such right--

**(i)** has a fixed duration of less than 15 years, or

**(ii)** is fixed as to amount and, without regard to this section, would be recoverable under a method similar to the unit-of-production method.

**(5)** Interests under leases and debt instruments. Any interest under--

**(A)** an existing lease of tangible property, or

**(B)** except as provided in subsection (d)(2)(B), any existing indebtedness.

**(6)** Mortgage servicing. Any right to service indebtedness which is secured by residential real property unless such right is acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than rights described in this paragraph) constituting a trade or business or substantial portion thereof.

**(7)** Certain transaction costs. Any fees for professional services, and any transaction costs, incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized under part III of subchapter C [26 USCS §§ 351 et seq.].

**(f)** Special rules.

**(1)** Treatment of certain dispositions, etc.

**(A)** In general. If there is a disposition of any amortizable section 197 intangible acquired in a transaction or series of related transactions (or any such intangible becomes worthless) and one or more other amortizable section 197 intangibles acquired in such transaction or series of related transactions are retained--

**(i)** no loss shall be recognized by reason of such disposition (or such worthlessness), and

**(ii)** appropriate adjustments to the adjusted bases of such retained intangibles shall be made for any loss not recognized under clause (i).

**(B)** Special rule for covenants not to compete. In the case of any section 197 intangible which is a covenant not to compete (or other arrangement) described in subsection (d)(1)(E), in no event shall such covenant or other arrangement be treated as disposed of (or becoming worthless) before the disposition of the entire interest described in such subsection in connection with which such covenant (or other arrangement) was entered into.

**(C)** Special rule. All persons treated as a single taxpayer under section 41(f)(1) [26 USCS § 41(F)(1)] shall be so treated for purposes of this paragraph.

**(2)** Treatment of certain transfers.

**(A)** In general. In the case of any section 197 intangible transferred in a transaction described in subparagraph (B), the transferee shall be treated as the transferor for purposes of applying this section with respect to so much of the adjusted basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.

**(B)** Transactions covered. The transactions described in this subparagraph are--

**(i)** any transaction described in section 332, 351, 361, 721, 731, 1031, or 1033, [26 USCS § 332, 351, 361, 721, 731,1031, or 1033] and

**(ii)** any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.

**(3)** Treatment of amounts paid pursuant to covenants not to compete, etc. Any amount paid or incurred pursuant to a covenant or arrangement referred to in subsection (d)(1)(E) shall be treated as an amount chargeable to capital account.

**(4)** Treatment of franchises, etc.

**(A)** Franchise. The term "franchise" has the meaning given to such term by section 1253(b)(1) [26 USCS § 1253(b)(1)].

**(B)** Treatment of renewals. Any renewal of a franchise, trademark, or trade name (or of a license, a permit, or other right referred to in subsection (d)(1)(D)) shall be treated as an acquisition. The preceding sentence shall only apply with respect to costs incurred in connection with such renewal.

**(C)** Certain amounts not taken into account. Any amount to which section 1253(d)(1) [26 USCS § 1253(d)(1)] applies shall not be taken into account under this section.

**(5)** Treatment of certain reinsurance transactions. In the case of any amortizable section 197 [26 USCS § 197] intangible resulting from an assumption reinsurance transaction, the amount taken into account as the adjusted basis of such intangible under this section shall be the excess of--

**(A)** the amount paid or incurred by the acquirer under the assumption reinsurance transaction, over

**(B)** the amount required to be capitalized under section 848 [26 USCS § 848] in connection with such transaction.Subsection (b) shall not apply to any amount required to be capitalized under section 848 [26 USCS § 848].

**(6)** Treatment of certain subleases. For purposes of this section, a sublease shall be treated in the same manner as a lease of the underlying property involved.

**(7)** Treatment as depreciable. For purposes of this chapter [26 USCS §§ 1 et seq.], any amortizable section 197 intangible shall be treated as property which is of a character subject to the allowance for depreciation provided in section 167[26 USCS § 167].

**(8)** Treatment of certain increments in value. This section shall not apply to any increment in value if, without regard to this section, such increment is properly taken into account in determining the cost of property which is not a section 197 intangible.

**(9)** Anti-churning rules. For purposes of this section--

**(A)** In general. The term "amortizable section 197 intangible" shall not include any section 197 intangible which is described in subparagraph (A) or (B) of subsection (d)(1) (or for which depreciation or amortization would not have been allowable but for this section) and which is acquired by the taxpayer after the date of the enactment of this section, if--

**(i)** the intangible was held or used at any time on or after July 25, 1991, and on or before such date of enactment by the taxpayer or a related person,

**(ii)** the intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before such date of enactment, and, as part of the transaction, the user of such intangible does not change, or

**(iii)** the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before such date of enactment.For purposes of this subparagraph, the determination of whether the user of property changes as part of a transaction shall be determined in accordance with regulations prescribed by the Secretary. For purposes of this subparagraph, deductions allowable under section 1253(d) [26 USCS § 1253(d)] shall be treated as deductions allowable for amortization.

**(B)** Exception where gain recognized. If--

**(i)** subparagraph (A) would not apply to an intangible acquired by the taxpayer but for the last sentence of subparagraph (C)(i), and

**(ii)** the person from whom the taxpayer acquired the intangible elects, notwithstanding any other provision of this title--

**(I)** to recognize gain on the disposition of the intangible, and

**(II)** to pay a tax on such gain which, when added to any other income tax on such gain under this title, equals such gain multiplied by the highest rate of income tax applicable to such person under this title,then subparagraph (A) shall apply to the intangible only to the extent that the taxpayer's adjusted basis in the intangible exceeds the gain recognized under clause (ii)(I).

**(C)** Related person defined. For purposes of this paragraph--

**(i)** Related person. A person (hereinafter in this paragraph referred to as the "related person") is related to any person if--

**(I)** the related person bears a relationship to such person specified in section 267(b) [26 USCS § 267(b)] or section 707(b)(1) [26 USCS § 707(b)(1)], or

**(II)** the related person and such person are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of section 41(f)(1) [26 USCS § 41(f)(1)]).For purposes of subclause (I), in applying section 267(b) or 707(b)(1) [26 USCS § 267(b) or 707(b)(1)], "20 percent" shall be substituted for "50 percent".

**(ii)** Time for making determination. A person shall be treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.

**(D)** Acquisitions by reason of death. Subparagraph (A) shall not apply to the acquisition of any property by the taxpayer if the basis of the property in the hands of the taxpayer is determined under section 1014(a) [26 USCS § 1014(a)].

**(E)** Special rule for partnerships. With respect to any increase in the basis of partnership property under section 732, 734, or 743 [26 USCS § 732, 734, or 743], determinations under this paragraph shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.

**(F)** Anti-abuse rules. The term "amortizable section 197 intangible" does not include any section 197 intangible acquired in a transaction, one of the principal purposes of which is to avoid the requirement of subsection (c)(1) that the intangible be acquired after the date of the enactment of this section or to avoid the provisions of subparagraph (A).

**(10)** Tax-exempt use property subject to lease.  In the case of any section 197 intangible which would be tax-exempt use property as defined in subsection (h) of section 168 [26 USCS § 168] if such section applied to such intangible, the amortization period under this section shall not be less than 125 percent of the lease term (within the meaning of section 168(i)(3) [26 USCS § 168(i)(3)]).

**(g)** Regulations.  The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including such regulations as may be appropriate to prevent avoidance of the purposes of this section through related persons or otherwise.

## History

(Added Aug. 10, 1993,P.L. 103-66, Title XIII, § 13261(a), 107 Stat. 532; Oct. 22, 2004, P.L. 108-357, Title VIII, Subtitle B, Part III, § 847(b)(3), Subtitle D, § 886(a), 118 Stat. 1602, 1641.)

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## § 263A. Capitalization and inclusion in inventory costs of certain expenses.

**(a)** Nondeductibility of certain direct and indirect costs.

**(1)** In general. In the case of any property to which this section applies, any costs described in paragraph (2)--

**(A)** in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs, and

**(B)** in the case of any other property, shall be capitalized.

**(2)** Allocable costs. The costs described in this paragraph with respect to any property are--

**(A)** the direct costs of such property, and

**(B)** such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property.Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.

**(b)** Property to which section applies. Except as otherwise provided in this section, this section shall apply to--

**(1)** Property produced by taxpayer. Real or tangible personal property produced by the taxpayer.

**(2)** Property acquired for resale.

**(A)** In general. Real or personal property described in section 1221(a)(1) [26 USCS § 1221(a)(1)] which is acquired by the taxpayer for resale.

**(B)** Exception for taxpayer with gross receipts of $ 10,000,000 or less. Subparagraph (A) shall not apply to any personal property acquired during any taxable year by the taxpayer for resale if the average annual gross receipts of the taxpayer (or any predecessor) for the 3-taxable year period ending with the taxable year preceding such taxable year do not exceed $ 10,000,000.

**(C)** Aggregation rules, etc. For purposes of subparagraph (B), rules similar to the rules of paragraphs (2) and (3) of section 448(c) [26 USCS § 448(c)] shall apply.

For purposes of paragraph (1), the term "tangible personal property" shall include a film, sound recording, video tape, book, or similar property.

**(c)** General exceptions.

**(1)** Personal use property. This section shall not apply to any property produced by the taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit.

**(2)** Research and experimental expenditures. This section shall not apply to any amount allowable as a deduction under section 174 [26 USCS § 174].

**(3)** Certain development and other costs of oil and gas wells or other mineral property. This section shall not apply to any cost allowable as a deduction under section 167(h), 179B, 263(c), 263(i), 291(b)(2), 616, or 617 [26 USCS § 167(h), 179B, 263(c), 263(i), 291(b)(2), 616, or 617].

**(4)** Coordination with long-term contract rules. This section shall not apply to any property produced by the taxpayer pursuant to a long-term contract.

**(5)** Timber and certain ornamental trees. This section shall not apply to--

**(A)** trees raised, harvested, or grown by the taxpayer other than trees described in clause (ii) of subsection (e)(4)(B) (after application of the last sentence thereof), and

**(B)** any real property underlying such trees.

**(6)** Coordination with section 59(e). Paragraphs (2) and (3) shall apply to any amount allowable as a deduction under section 59(e) [26 USCS § 59(e)] for qualified expenditures described in subparagraphs (B), (C), (D), and (E) of paragraph (2) thereof.

**(7)** Coordination with section 168(k)(5). This section shall not apply to any amount allowed as a deduction by reason of section 168(k)(5) (relating to special rules for certain plants bearing fruits and nuts).

**(d)** Exception for farming businesses.

**(1)** Section not to apply to certain property.

**(A)** In general. This section shall not apply to any of the following which is produced by the taxpayer in a farming business:

**(i)** Any animal.

**(ii)** Any plant which has a preproductive period of 2 years or less.

**(B)** Exception for taxpayers required to use accrual method. Subparagraph (A) shall not apply to any corporation, partnership, or tax shelter required to use an accrual method of accounting under section 447 or 448(a)(3) [26 USCS § 447 or 448(a)(3)].

**(2)** Treatment of certain plants lost by reason of casualty.

**(A)** In general. If plants bearing an edible crop for human consumption were lost or damaged (while in the hands of the taxpayer) by reason of freezing temperatures, disease, drought, pests, or casualty, this section shall not apply to any costs of the taxpayer of replanting plants bearing the same type of crop (whether on the same parcel of land on which such lost or damaged plants were located or any other parcel of land of the same acreage in the United States).

**(B)** Special rule for person with minority interest who materially participates. Subparagraph (A) shall apply to amounts paid or incurred by a person (other than the taxpayer described in subparagraph (A)) if--

**(i)** the taxpayer described in subparagraph (A) has an equity interest of more than 50 percent in the plants described in subparagraph (A) at all times during the taxable year in which such amounts were paid or incurred, and

**(ii)** such other person holds any part of the remaining equity interest and materially participates in the planting, maintenance, cultivation, or development of the plants described in subparagraph (A) during the taxable year in which such amounts were paid or incurred.The determination of whether an individual materially participates in any activity shall be made in a manner similar to the manner in which such determination is made under section 2032A(e)(6) [26 USCS § 2032A(e)(6)].

**(3)** Election to have this section not apply.

**(A)** In general. If a taxpayer makes an election under this paragraph, this section shall not apply to any plant produced in any farming business carried on by such taxpayer.

**(B)** Certain persons not eligible. No election may be made under this paragraph by a corporation, partnership, or tax shelter, if such corporation, partnership, or tax shelter is required to use an accrual method of accounting under section 447 or 448(a)(3) [26 USCS § 447 or 448(a)(3)].

**(C)** Special rule for citrus and almond growers. An election under this paragraph shall not apply with respect to any item which is attributable to the planting, cultivation, maintenance, or development of any citrus or almond grove (or part thereof) and which is incurred before the close of the 4th taxable year beginning with the taxable year in which the trees were planted. For purposes of the preceding sentence, the portion of a citrus or almond grove planted in 1 taxable year shall be treated separately from the portion of such grove planted in another taxable year.

**(D)** Election. Unless the Secretary otherwise consents, an election under this paragraph may be made only for the taxpayer's 1st taxable year which begins after December 31, 1986, and during which the taxpayer engages in a farming business. Any such election, once made, may be revoked only with the consent of the Secretary.

**(e)** Definitions and special rules for purposes of subsection (d).

**(1)** Recapture of expensed amounts on disposition.

**(A)** In general. In the case of any plant with respect to which amounts would have been capitalized under subsection (a) but for an election under subsection (d)(3)--

**(i)** such plant (if not otherwise section 1245 property) shall be treated as section 1245 property, and

**(ii)** for purposes of section 1245 [26 USCS § 1245], the recapture amount shall be treated as a deduction allowed for depreciation with respect to such property.

**(B)** Recapture amount. For purposes of subparagraph (A), the term "recapture amount" means any amount allowable as a deduction to the taxpayer which, but for an election under subsection (d)(3), would have been capitalized with respect to the plant.

**(2)** Effects of election on depreciation.

**(A)** In general. If the taxpayer (or any related person) makes an election under subsection (d)(3), the provisions of section 168(g)(2) [26 USCS § 168(g)(2)] (relating to alternative depreciation) shall apply to all property of the taxpayer used predominantly in the farming business and placed in service in any taxable year during which any such election is in effect.

**(B)** Related person. For purposes of subparagraph (A), the term "related person" means--

**(i)** the taxpayer and members of the taxpayer's family,

**(ii)** any corporation (including an S corporation) if 50 percent or more (in value) of the stock of such corporation is owned (directly or through the application of section 318 [26 USCS § 318]) by the taxpayer or members of the taxpayer's family,

**(iii)** a corporation and any other corporation which is a member of the same controlled group described in section 1563(a)(1) [26 USCS § 1563(a)(1)], and

**(iv)** any partnership if 50 percent or more (in value) of the interests in such partnership is owned directly or indirectly by the taxpayer or members of the taxpayer's family.

**(C)** Members of family. For purposes of this paragraph, the term "family" means the taxpayer, the spouse of the taxpayer, and any of their children who have not attained age 18 before the close of the taxable year.

**(3)** Preproductive period.

**(A)** In general. For purposes of this section, the term "preproductive period" means--

**(i)** in the case of a plant which will have more than 1 crop or yield, the period before the 1st marketable crop or yield from such plant, or

**(ii)** in the case of any other plant, the period before such plant is reasonably expected to be disposed of.For purposes of this subparagraph, use by the taxpayer in a farming business of any supply produced in such business shall be treated as a disposition.

**(B)** Rule for determining period. In the case of a plant grown in commercial quantities in the United States, the preproductive period for such plant if grown in the United States shall be based on the nationwide weighted average preproductive period for such plant.

**(4)** Farming business. For purposes of this section--

**(A)** In general. The term "farming business" means the trade or business of farming.

**(B)** Certain trades and businesses included. The term "farming business" shall include the trade or business of--

**(i)** operating a nursery or sod farm, or

**(ii)** the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees.For purposes of clause (ii), an evergreen tree which is more than 6 years old at the time severed from the roots shall not be treated as an ornamental tree.

**(5)** Certain inventory valuation methods permitted. The Secretary shall by regulations permit the taxpayer to use reasonable inventory valuation methods to compute the amount required to be capitalized under subsection (a) in the case of any plant.

**(f)** Special rules for allocation of interest to property produced by the taxpayer.

**(1)** Interest capitalized only in certain cases. Subsection (a) shall only apply to interest costs which are--

**(A)** paid or incurred during the production period, and

**(B)** allocable to property which is described in subsection (b)(1) and which has--

**(i)** a long useful life,

**(ii)** an estimated production period exceeding 2 years, or

**(iii)** an estimated production period exceeding 1 year and a cost exceeding $ 1,000,000.

**(2)** Allocation rules.

**(A)** In general. In determining the amount of interest required to be capitalized under subsection (a) with respect to any property--

**(i)** interest on any indebtedness directly attributable to production expenditures with respect to such property shall be assigned to such property, and

**(ii)** interest on any other indebtedness shall be assigned to such property to the extent that the taxpayer's interest costs could have been reduced if production expenditures (not attributable to indebtedness described in clause (i)) had not been incurred.

**(B)** Exception for qualified residence interest. Subparagraph (A) shall not apply to any qualified residence interest (within the meaning of section 163(h) [26 USCS § 163(h)]).

**(C)** Special rule for flow-through entities. Except as provided in regulations, in the case of any flow-through entity, this paragraph shall be applied first at the entity level and then at the beneficiary level.

**(3)** Interest relating to property used to produce property. This subsection shall apply to any interest on indebtedness allocable (as determined under paragraph (2)) to property used to produce property to which this subsection applies to the extent such interest is allocable (as so determined) to the produced property.

**(4)** Definitions. For purposes of this subsection--

**(A)** Long useful life. Property has a long useful life if such property is--

**(i)** real property, or

**(ii)** property with a class life of 20 years or more (as determined under section 168 [26 USCS § 168]).

**(B)** Production period. The term "production period" means, when used with respect to any property, the period--

**(i)** beginning on the date on which production of the property begins, and

**(ii)** ending on the date on which the property is ready to be placed in service or is ready to be held for sale.

**(C)** Production expenditures. The term "production expenditures" means the costs (whether or not incurred during the production period) required to be capitalized under subsection (a) with respect to the property.

**(g)** Production. For purposes of this section--

**(1)** In general. The term "produce" includes construct, build, install, manufacture, develop, or improve.

**(2)** Treatment of property produced under contract for the taxpayer. The taxpayer shall be treated as producing any property produced for the taxpayer under a contract with the taxpayer; except that only costs paid or incurred by the taxpayer (whether under such contract or otherwise) shall be taken into account in applying subsection (a) to the taxpayer.

**(h)** Exemption for free lance authors, photographers, and artists.

**(1)** In general. Nothing in this section shall require the capitalization of any qualified creative expense.

**(2)** Qualified creative expense. For purposes of this subsection, the term "qualified creative expense" means any expense--

**(A)** which is paid or incurred by an individual in the trade or business of such individual (other than as an employee) of being a writer, photographer, or artist, and

**(B)** which, without regard to this section, would be allowable as a deduction for the taxable year.Such term does not include any expense related to printing, photographic plates, motion picture films, video tapes, or similar items.

**(3)** Definitions. For purposes of this subsection--

**(A)** Writer. The term "writer" means any individual if the personal efforts of such individual create (or may reasonably be expected to create) a literary manuscript, musical composition (including any accompanying words), or dance score.

**(B)** Photographer. The term "photographer" means any individual if the personal efforts of such individual create (or may reasonably be expected to create) a photograph or photographic negative or transparency.

**(C)** Artist.

**(i)** In general. The term "artist" means any individual if the personal efforts of such individual create (or may reasonably be expected to create) a picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print edition.

**(ii)** Criteria. In determining whether any expense is paid or incurred in the trade or business of being an artist, the following criteria shall be taken into account:

**(I)** The originality and uniqueness of the item created (or to be created).

**(II)** The predominance of aesthetic value over utilitarian value of the item created (or to be created).

**(D)** Treatment of certain corporations.

**(i)** In general. If--

**(I)** substantially all of the stock of a corporation is owned by a qualified employee-owner and members of his family (as defined in section 267(c)(4) [26 USCS § 267(c)(4)]), and

**(II)** the principal activity of such corporation is performance of personal services directly related to the activities of the qualified employee-owner and such services are substantially performed by the qualified employee-owner,this subsection shall apply to any expense of such corporation which directly relates to the activities of such employee-owner in the same manner as if such expense were incurred by such employee-owner.

**(ii)** Qualified employee-owner. For purposes of this subparagraph, the term "qualified employee-owner" means any individual who is an employee-owner of the corporation (as defined in section 269A(b)(2) [26 USCS § 269A(b)(2)]) and who is a writer, photographer, or artist.

**(i)** Regulations. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including--

**(1)** regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of this section, and

**(2)** regulations providing for simplified procedures for the application of this section in the case of property described in subsection (b)(2).

## History

(Added Oct. 22, 1986,P.L. 99-514, Title VIII, § 803(a), 100 Stat. 2350; Nov. 10, 1988, P.L. 100-647, Title I, § 1008(b)(1)-(4), Title VI, § 6026(a)-(c), 102 Stat. 3437, 3438, 3691-3693; Dec. 19, 1989, P.L. 101-239, Title VII, § 7816(d)(1), 103 Stat. 2420; Dec. 17, 1999, P.L. 106-170, Title V, § 532(c)(2)(B), 113 Stat. 1930; Oct. 22, 2004, P.L. 108-357, Title III, Subtitle C, § 338(b)(2), 118 Stat. 1481; Aug. 8, 2005, P.L. 109-58, Title XIII, Subtitle B, § 1329(b), 119 Stat. 1020.)

(As amended Dec. 18, 2015,P.L. 114-113, Div Q, Title I, Subtitle B, § 143(b)(6)(H), 129 Stat. 3064.)



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# 26 USCS § 446

Current through PL 114-218, approved 7/29/16

***United States Code Service - Titles 1 through 54 > TITLE 26. INTERNAL REVENUE CODE > SUBTITLE A. INCOME TAXES > CHAPTER 1. NORMAL TAXES AND SURTAXES > SUBCHAPTER E. ACCOUNTING PERIODS AND METHODS OF ACCOUNTING > PART II. METHODS OF ACCOUNTING > SUBPART A. METHODS OF ACCOUNTING IN GENERAL***

## § 446. General rule for methods of accounting.

**(a)** General rule. Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

**(b)** Exceptions. If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

**(c)** Permissible methods. Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting--

**(1)** the cash receipts and disbursements method;

**(2)** an accrual method;

**(3)** any other method permitted by this chapter [26 USCS §§ 1 et seq.]; or

**(4)** any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

**(d)** Taxpayer engaged in more than one business. A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

**(e)** Requirement respecting change of accounting method. Except as otherwise expressly provided in this chapter [26 USCS §§ 1 et seq.], a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

**(f)** Failure to request change of method of accounting. If the taxpayer does not file with the Secretary a request to change the method of accounting, the absence of the consent of the Secretary to a change in the method of accounting shall not be taken into account--

**(1)** to prevent the imposition of any penalty, or the addition of any amount to tax, under this title, or

**(2)** to diminish the amount of such penalty or addition to tax.

## History

(Aug. 16, 1954, ch 736, 68A Stat. 151; Oct. 4, 1976,P.L. 94-455, Title XIX, § 1906 (b)(13)(A), 90 Stat. 1834; July 18, 1984, P.L. 98-369, Div A, Title I, § 161(a), 98 Stat. 696.)

Current through PL 114-218, approved 7/29/16



# § 460. Special rules for long-term contracts.

**(a)** Requirement that percentage of completion method be used. In the case of any long-term contract, the taxable income from such contract shall be determined under the percentage of completion method (as modified by subsection (b)).

**(b)** Percentage of completion method.

**(1)** Requirements of percentage of completion method. Except as provided in paragraph (3), in the case of any long-term contract with respect to which the percentage of completion method is used--

**(A)** the percentage of completion shall be determined by comparing costs allocated to the contract under subsection (c) and incurred before the close of the taxable year with the estimated total contract costs, and

**(B)** upon completion of the contract (or, with respect to any amount properly taken into account after completion of the contract, when such amount is so properly taken into account), the taxpayer shall pay (or shall be entitled to receive) interest computed under the look-back method of paragraph (2).In the case of any long-term contract with respect to which the percentage of completion method is used, except for purposes of applying the look-back method of paragraph (2) any income under the contract (to the extent not previously includible in gross income) shall be included in gross income for the taxable year following the taxable year in which the contract was completed. For purposes of subtitle F [26 USCS §§ 6001 et seq.] (other than sections 6654 and 6655 [26 USCS §§ 6654 and 6655]), any interest required to be paid by the taxpayer under subparagraph (B) shall be treated as an increase in the tax imposed by this chapter [26 USCS §§ 1 et seq.] for the taxable year in which the contract is completed (or, in the case of interest payable with respect to any amount properly taken into account after completion of the contract, for the taxable year in which the amount is so properly taken into account).

**(2)** Look-back method. The interest computed under the look-back method of this paragraph shall be determined by--

**(A)** first allocating income under the contract among taxable years before the year in which the contract is completed on the basis of the actual contract price and costs instead of the estimated contract price and costs,

**(B)** second, determining (solely for purposes of computing such interest) the overpayment or underpayment of tax for each taxable year referred to in subparagraph (A) which would result solely from the application of subparagraph (A), and

**(C)** then using the adjusted overpayment rate (as defined in paragraph (7)), compounded daily, on the overpayment or underpayment determined under subparagraph (B).For purposes of the preceding sentence, any amount properly taken into account after completion of the contract shall be taken into account by discounting (using the Federal mid-term rate determined under section 1274(d) [26 USCS § 1274(d)] as of the time such amount was properly taken into account) such amount to its value as of the completion of the contract. The taxpayer may elect with respect to any contract to have the preceding sentence not apply to such contract.

**(3)** Special rules.

**(A)** Simplified method of cost allocation. In the case of any long-term contract, the Secretary may prescribe a simplified procedure for allocation of costs to such contract in lieu of the method of allocation under subsection (c).

**(B)** Look-back method not to apply to certain contracts. Paragraph (1)(B) shall not apply to any contract--

**(i)** the gross price of which (as of the completion of the contract) does not exceed the lesser of--

**(I)** $ 1,000,000, or

**(II)** 1 percent of the average annual gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the contract was completed, and

**(ii)** which is completed within 2 years of the contract commencement date.For purposes of this subparagraph, rules similar to the rules of subsections (e)(2) and (f)(3) shall apply.

**(4)** Simplified look-back method for pass-thru entities.

**(A)** In general. In the case of a pass-thru entity--

**(i)** the look-back method of paragraph (2) shall be applied at the entity level,

**(ii)** in determining overpayments and underpayments for purposes of applying paragraph (2)(B)--

**(I)** any increase in the income under the contract for any taxable year by reason of the allocation under paragraph (2)(A) shall be treated as giving rise to an underpayment determined by applying the highest rate for such year to such increase, and

**(II)** any decrease in such income for any taxable year by reason of such allocation shall be treated as giving rise to an overpayment determined by applying the highest rate for such year to such decrease, and

**(iii)** any interest required to be paid by the taxpayer under paragraph (2) shall be paid by such entity (and any interest entitled to be received by the taxpayer under paragraph (2) shall be paid to such entity).

**(B)** Exceptions.

**(i)** Closely held pass-thru entities. This paragraph shall not apply to any closely held pass-thru entity.

**(ii)** Foreign contracts. This paragraph shall not apply to any contract unless substantially all of the income from such contract is from sources in the United States.

**(C)** Other definitions. For purposes of this paragraph--

**(i)** Highest rate. The term "highest rate" means--

**(I)** the highest rate of tax specified in section 11 [26 USCS § 11], or

**(II)** if at all times during the year involved more than 50 percent of the interests in the entity are held by individuals directly or through 1 or more other pass-thru entities, the highest rate of tax specified in section 1 [26 USCS § 1].

**(ii)** Pass-thru entity. The term "pass-thru entity" means any--

**(I)** partnership,

**(II)** S corporation, or

**(III)** trust.

**(iii)** Closely held pass-thru entity. The term "closely held pass-thru entity" means any pass-thru entity if, at any time during any taxable year for which there is income under the contract, 50 percent or more (by value) of the beneficial interests in such entity are held (directly or indirectly) by or for 5 or fewer persons. For purposes of the preceding sentence, rules similar to the constructive ownership rules of section 1563(e) [26 USCS § 1563(e)] shall apply.

**(5)** Election to use 10-percent method.

**(A)** General rule. In the case of any long-term contract with respect to which an election under this paragraph is in effect, the 10-percent method shall apply in determining the taxable income from such contract.

**(B)** 10-percent method. For purposes of this paragraph--

**(i)** In general. The 10-percent method is the percentage of completion method, modified so that any time which would otherwise be taken into account in computing taxable income with respect to a contract for any taxable year before the 10-percent year is taken into account in the 10-percent year.

**(ii)** 10-percent year. The term "10-percent year" means the 1st taxable year as of the close of which at least 10 percent of the estimated total contract costs have been incurred.

**(C)** Election. An election under this paragraph shall apply to all long-term contracts of the taxpayer which are entered into during the taxable year in which the election is made or any subsequent taxable year.

**(D)** Coordination with other provisions.

**(i)** Simplified method of cost allocation. This paragraph shall not apply to any taxpayer which uses a simplified procedure for allocation of costs under paragraph (3)(A).

**(ii)** Look-back method. The 10-percent method shall be taken into account for purposes of applying the look-back method of paragraph (2) to any taxpayer making an election under this paragraph.

**(6)** Election to have look-back method not apply in de minimis cases.

**(A)** Amounts taken into account after completion of contract. Paragraph (1)(B) shall not apply with respect to any taxable year (beginning after the taxable year in which the contract is completed) if--

**(i)** the cumulative taxable income (or loss) under the contract as of the close of such taxable year, is within

**(ii)** 10 percent of the cumulative look-back taxable income (or loss) under the contract as of the close of the most recent taxable year to which paragraph (1)(B) applied (or would have applied but for subparagraph (B)).

**(B)** De minimis discrepancies. Paragraph (1)(B) shall not apply in any case to which it would otherwise apply if--

**(i)** the cumulative taxable income (or loss) under the contract as of the close of each prior contract year, is within

**(ii)** 10 percent of the cumulative look-back income (or loss) under the contract as of the close of such prior contract year.

**(C)** Definitions. For purposes of this paragraph--

**(i)** Contract year. The term "contract year" means any taxable year for which income is taken into account under the contract.

**(ii)** Look-back income or loss. The look-back income (or loss) is the amount which would be the taxable income (or loss) under the contract if the allocation method set forth in paragraph (2)(A) were used in determining taxable income.

**(iii)** Discounting not applicable. The amounts taken into account after the completion of the contract shall be determined without regard to any discounting under the 2nd sentence of paragraph (2).

**(D)** Contracts to which paragraph applies. This paragraph shall only apply if the taxpayer makes an election under this subparagraph. Unless revoked with the consent of the Secretary, such an election shall apply to all long-term contracts completed during the taxable year for which election is made or during any subsequent taxable year.

**(7)** Adjusted overpayment rate.

**(A)** In general. The adjusted overpayment rate for any interest accrual period is the overpayment rate in effect under section 6621 [26 USCS § 6621] for the calendar quarter in which such interest accrual period begins.

**(B)** Interest accrual period. For purposes of subparagraph (A), the term "interest accrual period" means the period--

**(i)** beginning on the day after the return due date for any taxable year of the taxpayer, and

**(ii)** ending on the return due date for the following taxable year.For purposes of the preceding sentence, the term "return due date" means the date prescribed for filing the return of the tax imposed by this chapter [26 USCS §§ 1 et seq.] (determined without regard to extensions).

**(c)** Allocation of costs to contract.

**(1)** Direct and certain indirect costs. In the case of a long-term contract, all costs (including research and experimental costs) which directly benefit, or are incurred by reason of, the long-term contract activities of the taxpayer shall be allocated to such contract in the same manner as costs are allocated to extended period long-term contracts under section 451 [26 USCS § 451] and the regulations thereunder.

**(2)** Costs identified under cost-plus and certain federal contracts. In the case of a cost-plus long-term contract or a Federal long-term contract, any cost not allocated to such contract under paragraph (1) shall be allocated to such contract if such cost is identified by the taxpayer (or a related person), pursuant to the contract or Federal, State, or local law or regulation, as being attributable to such contract.

**(3)** Allocation of production period interest to contract.

**(A)** In general. Except as provided in subparagraphs (B) and (C), in the case of a long-term contract, interest costs shall be allocated to the contract in the same manner as interest costs are allocated to property produced by the taxpayer under section 263A(f) [26 USCS § 263A(f)].

**(B)** Production period. In applying section 263A(f) [26 USCS § 263A(f)] for purposes of subparagraph (A), the production period shall be the period--

**(i)** beginning on the later of--

**(I)** the contract commencement date, or

**(II)** in the case of a taxpayer who uses an accrual method with respect to long-term contracts, the date by which at least 5 percent of the total estimated costs (including design and planning costs) under the contract have been incurred, and

**(ii)** ending on the contract completion date.

**(C)** Application of de minimis rule. In applying section 263A(f) [26 USCS § 263A(f)] for purposes of subparagraph (A), paragraph (1)(B)(iii) of such section shall be applied on a contract-by-contract basis; except that, in the case of a taxpayer described in subparagraph (B)(i)(II) of this paragraph, paragraph (1)(B)(iii) of section 263A(f) [26 USCS § 263A(f)] shall be applied on a property-by-property basis.

**(4)** Certain costs not included. This subsection shall not apply to any--

**(A)** independent research and development expenses,

**(B)** expenses for unsuccessful bids and proposals, and

**(C)** marketing, selling, and advertising expenses.

**(5)** Independent research and development expenses. For purposes of paragraph (4), the term "independent research and development expenses" means any expenses incurred in the performance of research or development, except that such term shall not include--

**(A)** any expenses which are directly attributable to a long-term contract in existence when such expenses are incurred, or

**(B)** any expenses under an agreement to perform research or development.

**(6)** Special rule for allocation of bonus depreciation with respect to certain property.

**(A)** In general. Solely for purposes of determining the percentage of completion under subsection (b)(1)(A), the cost of qualified property shall be taken into account as a cost allocated to the contract as if subsection (k) of section 168 [26 USCS § 168] had not been enacted.

**(B)** Qualified property. For purposes of this paragraph, the term "qualified property" means property described in section 168(k)(2) [26 USCS § 168(k)(2)] which--

**(i)** has a recovery period of 7 years or less, and

**(ii)** is placed in service before January 1, 2020 (January 1, 2021 in the case of property described in section 168(k)(2)(B)).

**(d)** Federal long-term contract. For purposes of this section--

**(1)** In general. The term "Federal long-term contract" means any long-term contract

**(A)** to which the United States (or any agency or instrumentality thereof) is a party, or

**(B)** which is a subcontract under a contract described in subparagraph (A).

**(2)** Special rules for certain taxable entities. For purposes of paragraph (1), the rules of section 168(h)(2)(D) [26 USCS § 168(h)(2)(D)] (relating to certain taxable entities not treated as instrumentalities) shall apply.

**(e)** Exception for certain construction contracts.

**(1)** In general. Subsections (a), (b), and (c)(1) and (2) shall not apply to--

**(A)** any home construction contract, or

**(B)** any other construction contract entered into by a taxpayer--

**(i)** who estimates (at the time such contract is entered into) that such contract will be completed within the 2-year period beginning on the contract commencement date of such contract, and

**(ii)** whose average annual gross receipts for the 3 taxable years preceding the taxable year in which such contract is entered into do not exceed $ 10,000,000.In the case of a home construction contract with respect to which the requirements of clauses (i) and (ii) of subparagraph (B) are not met, section 263A [26 USCS § 263A] shall apply notwithstanding subsection (c)(4) thereof.

**(2)** Determination of taxpayer's gross receipts. For purposes of paragraph (1), the gross receipts of--

**(A)** all trades or businesses (whether or not incorporated) which are under common control with the taxpayer (within the meaning of section 52(b) [26 USCS § 52(b)]),

**(B)** all members of any controlled group of corporations of which the taxpayer is a member, and

**(C)** any predecessor of the taxpayer or a person described in subparagraph (A) or (B),for the 3 taxable years of such persons preceding the taxable year in which the contract described in paragraph (1) is entered into shall be included in the gross receipts of the taxpayer for the period described in paragraph (1)(B). The Secretary shall prescribe regulations which provide attribution rules that take into account, in addition to the persons and entities described in the preceding sentence, taxpayers who engage in construction contracts through partnerships, joint ventures, and corporations.

**(3)** Controlled group of corporations. For purposes of this subsection, the term "controlled group of corporations" has the meaning given to such term by section 1563(a) [26 USCS § 1563(a)], except that--

**(A)** "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)(1) [26 USCS § 1563(a)(1)], and

**(B)** the determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of section 1563 [26 USCS § 1563].

**(4)** Construction contract. For purposes of this subsection, the term "construction contract" means any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property.

**(5)** Special rule for residential construction contracts which are not home construction contracts. In the case of any residential construction contract which is not a home construction contract, subsection (a) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1989 [enacted Dec. 19, 1989]) shall apply except that such subsection shall be applied--

**(A)** by substituting "70 percent" for "90 percent" each place it appears, and

**(B)** by substituting "30 percent" for "10 percent" .

**(6)** Definitions relating to residential construction contracts. For purposes of this subsection--

**(A)** Home construction contract. The term "home construction contract" means any construction contract if 80 percent or more of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to activities referred to in paragraph (4) with respect to--

**(i)** dwelling units (as defined in section 168(e)(2)(A)(ii) [26 USCS § 168(e)(2)(A)(ii)]) contained in buildings containing 4 or fewer dwelling units (as so defined), and

**(ii)** improvements to real property directly related to such dwelling units and located on the site of such dwelling units.For purposes of clause (i), each townhouse or rowhouse shall be treated as a separate building.

**(B)** Residential construction contract. The term "residential construction contract" means any contract which would be described in subparagraph (A) if clause (i) of such subparagraph reads as follows:"(i) dwelling units (as defined in section 168(e)(2)(A)(ii) [26 USCS § 168(e)(2)(A)(ii)]), and".

**(f)** Long-term contract. For purposes of this section--

**(1)** In general. The term "long-term contract" means any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into.

**(2)** Special rule for manufacturing contracts. A contract for the manufacture of property shall not be treated as a long-term contract unless such contract involves the manufacture of--

**(A)** any unique item of a type which is not normally included in the finished goods inventory of the taxpayer, or

**(B)** any item which normally requires more than 12 calendar months to complete (without regard to the period of the contract).

**(3)** Aggregation, etc. For purposes of this subsection, under regulations prescribed by the Secretary--

**(A)** 2 or more contracts which are interdependent (by reason of pricing or otherwise) may be treated as 1 contract, and

**(B)** a contract which is properly treated as an aggregation of separate contracts may be so treated.

**(g)** Contract commencement date. For purposes of this section, the term "contract commencement date" means, with respect to any contract, the first date on which any costs (other than bidding expenses or expenses incurred in connection with negotiating the contract) allocable to such contract are incurred.

**(h)** Regulations. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations to prevent the use of related parties, pass-thru entities, intermediaries, options, or other similar arrangements to avoid the application of this section.

## History

(Added Oct. 22, 1986,P.L. 99-514, Title VIII, § 804(a), 100 Stat. 2358; Dec. 22, 1987, P.L. 100-203, Title X, § 10203(a), 101 Stat. 1330-394; Nov. 10, 1988, P.L. 100-647, Title I, § 1008(c)(1), (2), (4), Title V, § 5041(a)-(b)(3), (c), (d), 102 Stat. 3438, 3439, 3673, 3674; Dec. 19, 1989, P.L. 101-239, Title VII, §§ 7621(a)-(c), 7811(e), 7815(e)(1), 103 Stat. 2375, 2376, 2408, 2419; Nov. 5, 1990, P.L. 101-508, Title XI, § 11812(b)(8), 104 Stat. 1388-535; Aug. 20, 1996, P.L. 104-188, Title I, §§ 1702(h)(15), 1704(t)(28), 110 Stat. 1874, 1888; Aug. 5, 1997, P.L. 105-34, Title XII, § 1211(a), (b), 111 Stat. 998, 999; Sept. 27, 2010, P.L. 111-240, Title II, Subtitle A, Part II, § 2023(a), 124 Stat. 2559; Jan. 2, 2013, P.L. 112-240, Title III, Sec. 331(b), 126 Stat. 2336; Dec. 19, 2014, P.L. 113-295, Div A, Title I, Subtitle B, § 125(b), 128 Stat. 4016.)

(As Dec. 18, 2015,P.L. 114-113, Div Q, Title I, Subtitle B, § 143(a)(2), (b)(6)(I), 129 Stat. 3056, 3064.)



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# 26 USCS § 471

Current through PL 114-218, approved 7/29/16

***United States Code Service - Titles 1 through 54 > TITLE 26. INTERNAL REVENUE CODE > SUBTITLE A. INCOME TAXES > CHAPTER 1. NORMAL TAXES AND SURTAXES > SUBCHAPTER E. ACCOUNTING PERIODS AND METHODS OF ACCOUNTING > PART II. METHODS OF ACCOUNTING > SUBPART D. INVENTORIES***

## § 471. General rule for inventories.

**(a)** General rule. Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

**(b)** Estimates of inventory shrinkage permitted. A method of determining inventories shall not be treated as failing to clearly reflect income solely because it utilizes estimates of inventory shrinkage that are confirmed by a physical count only after the last day of the taxable year if--

**(1)** the taxpayer normally does a physical count of inventories at each location on a regular and consistent basis, and

**(2)** the taxpayer makes proper adjustments to such inventories and to its estimating methods to the extent such estimates are greater than or less than the actual shrinkage.

**(c)** Cross reference. For rules relating to capitalization of direct and indirect costs of property, see section 263A [26 USCS § 263A].

## History

(Aug. 16, 1954, ch 736, 68A Stat. 159; Oct. 4, 1976,P.L. 94-455, Title XIX, § 1906(b)(13)(A), 90 Stat. 1834; Oct. 22, 1986, P.L. 99-514, Title VIII, § 803(b)(4), 100 Stat. 2356; Aug. 5, 1997, P.L. 105-34, Title IX, § 961(a), 111 Stat. 891.)

# 34 TAC § 3.291

This document reflects all regulations in effect as of July 31, 2016

***Texas Administrative Code > TITLE 34. PUBLIC FINANCE > PART 1. COMPTROLLER OF PUBLIC ACCOUNTS > CHAPTER 3. TAX ADMINISTRATION > SUBCHAPTER O. STATE AND LOCAL SALES AND USE TAXES***

## § 3.291. Contractors

**(a)** Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

**(1)** Agreed contract price of materials incorporated into the realty--The price specified in the contract for the incorporated materials, i.e., tangible personal property that becomes a part of the real property, plus any additional charges directly attributable to the incorporated materials. For example, profit that is calculated as a percentage of the cost of materials, cost of transportation of the materials, and markup or handling charges that relate directly to the materials charge are included in the agreed contract price. A charge that is calculated as a percentage of the total contract cost is not considered a part of the agreed contract price of materials incorporated into realty. The agreed contract price of incorporated materials cannot be less than the price that the contractor paid for the materials.

**(2)** Consumable item--Nondurable tangible personal property that is used to improve realty and, after being used once for its intended purpose, is completely used up or destroyed. Examples of consumable items are nonreusable concrete forms, nonreusable drop cloths, barricade tape, natural gas, and electricity. The term "consumable item" does not include machinery, equipment, accessories to machinery or equipment, repair or replacement parts for machinery or equipment, or any rented or leased item.

**(3)** Contractor--Any person who builds new improvements to residential or nonresidential real property, completes any part of an uncompleted new structure that is an improvement to residential or nonresidential real property, makes improvements to real property as part of periodic and scheduled maintenance of nonresidential real property, or repairs, restores, maintains, or remodels residential real property, and who, in making the improvement, incorporates tangible personal property into the real property that is improved. The term includes subcontractors but does not include material men, suppliers, or persons who provide taxable real property services. Persons who provide real property services should refer to § 3.356 of this title (relating to Real Property Service). Persons who repair, restore, or remodel nonresidential real property are providing taxable services and should refer to § 3.357 of this title (relating to Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance). Persons who repair, restore, or remodel chemical plants or petrochemical refineries should refer to § 3.362 of this title (relating to Labor Relating to Increasing Capacity in a Production Unit in a Petrochemical Refinery or Chemical Plant).

**(4)** Equipment--Tangible personal property that a contractor uses that is not a consumable item or an incorporated material. Examples include tools, machinery, implements, and accessories and repair or replacement parts for the equipment.

**(5)** Exempt contract--A contract for the improvement of real property with an entity that is exempted under Tax Code, § 151.309 or § 151.310. An example of an exempt contract is a contract with a nonexempt entity to improve real property for the primary use and benefit of an organization exempted under Tax Code, § 151.309 or § 151.310, provided that the improvements relate to the exempt purpose of an organization that is exempted under Tax Code, § 151.310(a)(1) or (a)(2). Another example is a contract for development work covered under subsection (d) of this section. See § 3.322 of this title (relating to Exempt Organizations).

**(6)** Improvements to realty--See § 3.347 of this title (relating to Improvements to Realty).

**(7)** Incorporated materials--Tangible personal property that becomes a part of any building or other structure, project, development, or other permanent improvement on or to such real property including tangible personal property that, after installation, becomes real property by virtue of being embedded in or permanently affixed to the land or structure constituting realty and which property after installation is necessary to the intended usefulness of the building or other structure.

**(8)** Lump-sum contract--A contract in which the agreed contract price is one lump-sum amount and in which the charges for incorporated materials are not separate from any charges for skill and labor, including fabrication, installation, and other labor that the contractor performs. For example, guaranteed-maximum contracts are considered lump-sum contracts when the charges for incorporated materials and the charges for skill and all labor are not separately stated. Contracts to improve realty that do not break out all charges for labor, including fabrication labor, are considered lump-sum contracts. For example, a contractor who fabricates and incorporates cabinets into realty under a contract that includes the fabrication labor in the agreed contract price of materials is a lump-sum contractor. Contracts to improve realty that have a zero charge for materials or for labor are considered lump-sum contracts. Separated invoices issued to the customer will not change a lump-sum contract into a separated contract unless the terms of the contract require separated invoices.

**(9)** New construction--All new improvements to real property, including initial finish-out work to the interior or exterior of the improvement. An example is a multiple story building that has had only its first floor finished and occupied. The initial finish-out of each additional floor before initial occupancy or use is new construction. New construction also includes the addition of new usable square footage to an existing building. Examples include the addition of a new wing onto an existing building. Reallocation of existing square footage inside a building is remodeling and does not constitute the addition of new square footage. For example, the removal or relocation of interior walls to expand the size of a room or the finish out of an office space that was previously used for storage is remodeling. Raising the ceiling of a room or the roof of a building is not new construction if new usable square footage is not created.

**(10)** Ready mix concrete contractor--A contractor who manufactures or produces concrete for construction purposes and incorporates the concrete into the property improved.

**(11)** Sale and installation of tangible personal property--Includes a contract to furnish and install machinery, equipment, or other tangible property that is not essential to the building or structure, nor adapted or intended to become a part of the realty, but which incidentally may, on account of its nature, be temporarily attached to the realty without loss of its identity as a particular piece of machinery, equipment, or property and, if attached, is readily removable without substantial damage to the unit or realty or without destruction of the intended usefulness of the realty.

**(12)** Residence or residential property--Property that is used as a family dwelling, a multifamily apartment or housing complex, nursing home, condominium, or retirement home. The term includes homeowners association-owned and apartment-owned swimming pools that are for the use of the homeowners or tenants, laundry rooms for tenants' use, and other common areas for tenants' use. The term does not include hotels or any other facilities that are subject to the hotel occupancy tax.

**(13)** Separated contract--A contract in which the agreed contract price is divided into a separately stated agreed contract price for incorporated materials and a separately stated amount for all skill and labor that includes fabrication, installation, and other labor that is performed by the contractor. If prices of incorporated materials and labor are separately stated in any part of the contract or in a document that becomes part of the contract according to the terms of the contract, adding the charges together to give a sum total does not change the contract into a lump-sum contract. For example, a contract that requires separated invoices is a separated contract. Cost-plus contracts are considered separated contracts if the cost of labor is separately stated from the cost for incorporated materials.

**(b)** Tax responsibilities of contractors who improve real property of nonexempt customers.

**(1)** Equipment. A contractor must pay sales tax at the time of purchase, lease, or rental on the sales price of equipment used to perform a contract. A contractor must accrue and remit use tax on the sales price of equipment purchased, leased, or rented for use in Texas from an out-of-state seller unless the out-of-state seller collected Texas use tax. See § 3.346 of this title (relating to Use Tax). Texas allows a credit against Texas use tax when the same property is subject to a legally imposed sales or use tax of another state. See § 3.338 of this title (relating to Multistate Tax Credits and Allowance of Credit for Tax Paid to Suppliers).

**(2)** Consumable item. Except as provided by subparagraph (B) of this paragraph, a contractor must pay tax at the time of purchase on consumable items that are not physically incorporated into the customer's property.

**(A)** A contractor may not collect tax from the customer on a charge for consumable items except as provided by subparagraph (B) of this paragraph.

**(B)** A contractor who has a separated contract may issue a properly completed resale certificate to a supplier in lieu of tax for consumable items if title to the consumable items transfers to the contractor's customer at or before the time that the contractor takes possession of the consumable items, and further if the consumable items are immediately marked, labeled, or otherwise physically identified as the customer's property, when practicable. The contractor must separately state the charge for these consumable items to the customer and must collect sales tax from the customer, unless the customer qualifies for exemption under Tax Code, § 151.309 or § 151.310, or under other provisions that grant the customer exemption from sales tax on its purchases. See § 3.322 of this title (relating to Exempt Organizations).

**(3)** Lump-sum contracts.

**(A)** A contractor who performs lump-sum contracts owes tax on all materials, consumable items, equipment, taxable services, and other taxable items that are used by the contractor or incorporated into a customer's property. The contractor must pay tax to suppliers when the contractor purchases, leases, or rents the taxable items. The contractor must accrue and remit use tax on taxable items that are purchased, leased, or rented from an out-of-state seller unless the out-of-state seller collected and gave the contractor a receipt for Texas use tax. The contractor shall not collect from a customer any amount represented to be tax on a lump-sum charge or on any portion of the charge except as provided under subparagraph (E) of this paragraph. A lump-sum contractor must refund to the customer any tax that is collected in error or the contractor must remit the tax to the state. The contractor may not retain such tax.

**(B)** A contractor who, in addition to performing lump-sum contracts, sells, leases, or rents taxable items at retail or performs separated contracts may maintain a tax-free inventory of items that are held for resale. A contractor who, in addition to performing lump-sum contracts, performs nonresidential real property repair, restoration, and remodeling services and resells taxable items as part of those taxable services may also maintain a tax-free inventory of items that are held for resale. See § 3.357 of this title (relating to Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance). A contractor may issue a properly completed resale certificate instead of paying tax on items that are purchased for a tax-free inventory when the contractor does not know at the time of purchase whether the item will be resold or used in the performance of a lump-sum contract. A contractor must hold a sales tax permit to issue a resale certificate, and must collect, report, and remit tax to the comptroller as required by § 3.286 of this title (relating to Seller's and Purchaser's Responsibilities) when the contractor sells, leases, or rents taxable items. A contractor who separately states a charge for equipment that the contractor uses is not renting that equipment to the customer.

**(C)** A contractor who purchases taxable items under a valid resale certificate and uses the items in a taxable manner owes sales or use tax on the items. For example, a contractor who incorporates materials from a tax-free resale inventory into realty under a lump-sum contract must accrue and remit tax based on the purchase price of the materials. The contractor must remit the tax to the comptroller for the reporting period in which the materials were used. A contractor who purchases items that are specifically intended for use in a lump-sum contract may not issue resale certificates in lieu of tax for such items. See § 3.285 of this title (relating to Resale Certificates; Sales for Resale).

**(D)** A contractor may not accept a direct payment exemption certificate when the contractor performs a lump-sum contract for a person who holds a direct payment permit. The lump-sum contractor owes tax on all taxable items that are used on the job or that are incorporated into the direct payment permit holder's realty. A direct payment permit holder may not authorize a contractor or any other person to purchase tax free any taxable item through use of the direct payment permit holder's permit. See § 3.288 of this title (relating to Direct Payment Procedures and Qualifications).

**(E)** A ready mix concrete contractor must separate the charge for the concrete from other charges associated with the contract, and invoice the customer for each yard of concrete produced and consumed for the improvement of real property. The ready mix concrete contractor may issue a resale certificate in lieu of paying sales tax on taxable items (e.g., processed materials) incorporated into the concrete. The ready mix concrete contractor must collect and remit the tax due on the concrete produced and consumed. The tax rate in effect at the job site location is applied to the greater of the actual invoice price of the component materials or the fair market value of the concrete incorporated into the project. For the purposes of this subparagraph, fair market value is the amount that a purchaser would pay on the open market for concrete. The fair market value will be determined on a case by case basis, taking into consideration relevant factors such as cost of component materials, location of job site, volume, and prices charged by other concrete contractors in the area. Contracts entered into prior to September 1, 2007, are excluded from the requirements of this subparagraph provided the contract terms do not allow for the pass-through of taxes by the ready mix concrete contractor to the purchaser for the duration of the contract period. This subparagraph does not apply to ready mix concrete contractors providing concrete for a public works project.

**(4)** Separated contracts.

**(A)** Except as otherwise provided in this section, a contractor who performs a separated contract is a retailer of all materials that are physically incorporated into the realty that is being improved. As a retailer, the contractor must collect tax from the customer based upon the agreed contract price of the incorporated materials. The tax rate must be applied to the agreed contract price of materials, or to the price of the materials to the contractor, whichever is greater. A contractor who performs a separated contract is also a retailer of taxable services that are sold under the provisions of subparagraph (D) of this paragraph, and of consumable items that are sold under the provisions of paragraph (2)(B) of this subsection. The contractor may accept a properly completed resale or exemption certificate from a customer who claims an exemption.

**(B)** A contractor who performs a separated contract must hold a sales tax permit and collect, report, and remit the tax as required by § 3.286 of this title (relating to Seller's and Purchaser's Responsibilities). A contractor who purchases taxable items for resale as part of a separated contract may issue resale certificates to suppliers in lieu of tax. See § 3.285 of this title (relating to Resale Certificate; Sales for Resale). A contractor may not issue a resale certificate and must pay tax on the purchase, rental, or lease of equipment that is intended for use in the performance of a contract.

**(C)** A contractor may maintain a tax-paid inventory of materials. If the contractor incorporates tax-paid materials into realty under a separated contract or sells them at retail or transfers the materials to a customer as part of a taxable service, then the contractor must collect tax from the customer based upon the agreed contract price of the materials or upon the sales price of the taxable service. The contractor may claim a credit for tax paid on materials resold to customers. The contractor must remit tax to the comptroller on any difference that exists between the price that the customer paid and the price that the contractor paid.

**(D)** A contractor who performs separated contracts may issue properly completed resale certificates in lieu of tax on taxable services that the contractor resells to its customers. Examples include landscaping, surveying, security services (alarm systems), that are incorporated into the customer's realty, and the final clean-up (janitorial services) of the construction site. The charges for taxable services that are resold to the customer must be separated from the charges for incorporated materials and other charges, and the contractor must collect tax from the customer on charges for the taxable services and incorporated materials. A contractor who performs a separated contract may not issue a resale certificate for a taxable service that the contractor uses or consumes, such as a security service to secure the job site, telecommunication service, and daily clean-up (janitorial service or garbage collection and removal) of the construction site. A contractor who performs residential new construction should refer to paragraph (7) of this subsection.

**(E)** A contractor who improves realty for a direct payment permit holder may accept a properly completed direct payment exemption certificate in lieu of tax on all tangible personal property that is incorporated into the direct payment permit holder's realty. The contractor owes tax on equipment the contractor purchases, rents, or leases for use in the performance of the contract with a direct payment permit holder. See § 3.288 of this title (relating to Direct Payment Procedures and Qualifications). A contractor who performs a separated contract may not accept a direct payment exemption certificate in lieu of tax on consumable items unless paragraph (2)(B) of this subsection applies. A contractor who performs a separated contract may accept a direct payment exemption certificate in lieu of tax on taxable services only under the circumstances set out in paragraph (4)(D) of this subsection.

**(5)** Contracts versus bids and change orders. For tax purposes, the terms of a contract control over the terms of a bid. For example, if the bid is lump-sum but the written contract is separated, then the contract determines the tax responsibilities of the parties, and the customer is liable for tax on incorporated materials. The terms of a contract also control change orders. If the contract is lump-sum, then change orders will be treated as lump-sum even if the change orders show charges for incorporated materials separate from other charges. If the contract is separated and change orders are for lump-sum amounts, then the lump-sum amounts will be treated as charges for incorporated materials unless the contractor can reasonably demonstrate the portion attributable to labor.

**(6)** Different types of contracts between contractors and subcontractors. For tax purposes, subcontractors are not required to use the same type of contract as the general contractor. For example, a general or prime contract may be lump-sum, while some or all subcontracts may be separated. Each subcontractor's individual contract governs the subcontractor's tax responsibilities. In the example given, the subcontractors with separated contracts must collect sales tax from the general contractor. The general contractor must not collect any tax from the general contractor's customer. When the general or prime contract separately states labor and incorporated materials but some of the subcontracts are lump-sum, the prime or general contractor should treat the lump-sum charges as part of its separately stated labor charge and should not collect tax from the prime contractor's customer on those charges from lump-sum subcontractors.

**(7)** Real property services. A contractor is not required to pay tax on real property services that are purchased as part of the construction of a new residential structure or as part of an improvement that is located immediately adjacent to the new structure and that is used in the residential occupancy of the structure. The contractor must issue a properly completed exemption certificate or other acceptable documentation to the service provider. If the comptroller subsequently determines that the work is taxable, then the contractor will be liable for all taxes, penalties, and interest that accrue upon such purchases. For the purposes of this paragraph, "contractor" includes a builder, developer, speculative builder, or other person who acts as a builder to improve residential real property.

**(8)** Materials that customers provide. A contract may specify that a customer will provide materials and that the person who performs improvements will provide the skill and labor that are necessary to incorporate the materials into realty. Under this type of contract, the person who provides the skill and labor will not incur tax liability on the materials. The customer is liable for the tax on the materials and must pay tax at the time of purchase of the materials.

**(9)** Noninstalled items. A person who manufactures an item for sale but who is not responsible for the incorporation of the item into realty is a manufacturer who is subject to the provisions of § 3.300 of this title (relating to Manufacturing; Custom Manufacturing; Fabricating; Processing). For example, cabinet makers who do not affix the cabinets to realty are manufacturers and not contractors.

**(10)** Local tax. A contractor's responsibility for local sales and use taxes depends on the type of contract entered into with the customer.

**(A)** A contractor who has entered into a separated contract with the customer must collect local taxes on the charge for materials based on the location of the job site.

**(B)** A contractor who has entered into a lump-sum contract with the customer is the consumer of all materials used to perform a lump-sum contract. (i) The lump-sum contractor should pay tax to suppliers on all materials at the time of purchase, unless the contractor maintains a valid tax-free inventory or holds a direct pay permit. (ii) When the local sales taxes collected by the supplier are less than the 2.0% local tax cap, additional local use taxes are due based on the location where the goods are first stored or used. Local use tax is not due if the supplier collected a local sales tax for the same type of taxing jurisdiction. (iii) When a lump-sum contractor has items shipped to the jobsite from outside of Texas, the contractor is responsible for accruing local taxes based on the location of the jobsite. (iv) The lump-sum contractor must accrue local use tax based on the purchase price of the taxable item. The local use tax is due in the reporting period in which the item was first stored, used, or otherwise consumed in a local taxing entity.

**(11)** Enterprise projects and defense readjustment projects. In order for an enterprise project or a defense readjustment project to avail itself of certain sales tax refunds, the project must enter into a separated contract, and the charges for items that qualify for enterprise project or defense readjustment project refunds must be separately stated. A contractor who performs a separated contract must collect sales tax from the project on the sales price of the incorporated materials. See § 3.329 of this title (relating to Enterprise Projects, Enterprise Zones, and Defense Readjustment Zones).

**(12)** Manufacturing facilities. For a manufacturer to qualify for sales tax exemptions on manufacturing equipment that is installed under a contract to improve real property, the manufacturer must enter into a separated contract. Additionally, the contract must separately state the charge for the qualifying manufacturing equipment. See § 3.300 of this title (relating to Manufacturing; Custom Manufacturing; Fabricating; Processing).

**(c)** Tax responsibilities of contractors who perform lump-sum and separated contracts for exempt organizations.

**(1)** Exemption certificates and other required proof of exemption. A contractor must obtain properly completed exemption certificates to document exempt contracts. Written contracts or written purchase orders that are issued by governmental entities exempted under Tax Code, § 151.309, are acceptable documentation of exempt contracts.

**(2)** Contractor liability.

**(A)** A contractor may claim an exemption under Tax Code, § 151.311, on a purchase of a taxable item for use under a contract to improve realty for an organization that is exempt under Tax Code, § 151.309 or § 151.310. If the comptroller subsequently determines that the organization is not exempt, then the contractor is liable for all taxes, penalties, and interest that accrue upon such purchase. If the validity of a claimed exemption or the exempt status of the customer is unclear, then the contractor may not accept the exemption certificate in good faith and should request additional evidence of the exempt status of the contract. If the customer claims to be an exempt organization, then a letter of sales and use tax exemption from the comptroller that is addressed to the customer relieves the contractor from further inquiry regarding the exempt status of the customer. See § 3.287 of this title (relating to Exemption Certificates).

**(B)** A contract with a private party to improve real property owned by an exempt entity, other than a governmental entity described in Tax Code, § 151.309, is not an exempt contract if the improvement to real property is for the primary use and benefit of the private party. However, a contractor in a non-exempt contract may purchase tax free tangible personal property that is used to improve real property owned by a governmental entity described in Tax Code, § 151.309, if that tangible personal property is donated to the governmental entity and if the following conditions are satisfied: (i) the contract between the contractor and the private party is a separated contract. See subsection (b) of this section for a discussion of lump-sum and separated contracts; (ii) the contract provides that title to the materials used to perform the contract passes to the private party when the materials are delivered to the job site but before they are incorporated into the realty or used by either the contractor or the private party; and (iii) the contract provides that the private party intends to donate the materials to the governmental entity before the materials are incorporated into the realty or used by the contractor. The private party must provide the contractor with a letter of intent or other document from the governmental entity that states its intent to accept the property.

**(3)** Materials that exempt customers provide. A contract may specify that the exempt customer will provide the materials and the contractor will provide the skill and labor that are necessary to perform the contract. Under this type of contract, the contractor will not incur tax liability on the materials. The exempt customer may issue exemption certificates to suppliers in lieu of tax when purchasing the materials. Materials that are incorporated into real property improvements that are not related to the exempt purpose of the customer exempt under Tax Code, § 151.310(a)(1) or (2), are taxable. In this situation, the exempt customer must pay tax to suppliers when purchasing the materials. See also § 3.322 of this title (relating to Exempt Organizations).

**(4)** Exempt items. The following items are exempt from sales and use tax when purchased for use in the performance of an exempt contract:

**(A)** tangible personal property that is incorporated into the realty;

**(B)** consumable items that are necessary and essential to the contract and are completely consumed at the job site; and

**(C)** taxable services that are performed at the job site and are: (i) expressly required by the exempt contract to be provided or purchased by the contractor; or (ii) integral to the performance of the exempt contract.

**(5)** Contractor's exemption or resale certificate. A contractor who performs a lump-sum or separated contract may issue a properly completed exemption certificate to a supplier for the purchase of exempt items that are identified in paragraph (4) of this subsection. The certificate must be properly completed and identify the contractor as the purchaser, the exempt entity for whom the improvements are made, and the project for which the items are being purchased. See § 3.287 of this title (relating to Exemption Certificates). A contractor may choose to issue a properly completed resale certificate when purchasing materials that will be incorporated into the customer's realty under a separated contract.

**(6)** Equipment. All machinery and equipment, including repair and replacement parts and accessories, that a contractor uses to perform contracts for any exempt entity are taxable. A contractor who purchases, rents, or leases equipment for use on a contract to improve realty for an exempt entity must pay tax on that purchase, rental, or lease.

**(d)** Development work. For the purposes of this subsection, development work means a contract with a private party to improve real property by building public infrastructure, such as roads or sewer lines, provided that the improvements are dedicated to and will be accepted by a governmental entity. To qualify as an exempt contract, the private party must dedicate the realty and the improvements to the governmental entity before the work begins, and the governmental entity must accept or conditionally accept the realty and the improvements.

## History

**SOURCE:**

The provisions of this § 3.291 adopted to be effective July 22, 2001, 26 TexReg 5434; amended to be effective May 27, 2008, 33 TexReg 4185

TEXAS ADMINISTRATIVE CODE

# 34 TAC § 3.588

This document reflects all regulations in effect as of July 31, 2016

***Texas Administrative Code > TITLE 34. PUBLIC FINANCE > PART 1. COMPTROLLER OF PUBLIC ACCOUNTS > CHAPTER 3. TAX ADMINISTRATION > SUBCHAPTER V. FRANCHISE TAX***

## § 3.588. Margin: Cost of Goods Sold

**(a)** Effective Date. The provisions of this section apply to franchise tax reports originally due on or after January 1, 2008.

**(b)** Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

**(1)** Arm's length--The standard of conduct under which entities that are not related parties and that have substantially equal bargaining power, each acting in its own interest, would negotiate or carry out a particular transaction.

**(2)** Computer program--A series of instructions that are coded for acceptance or use by a computer system and that are designed to permit the computer system to process data and provide results and information. The series of instructions may be contained in or on magnetic tapes, printed instructions, or other tangible or electronic media.

**(3)** Goods--Real or tangible personal property sold in the ordinary course of business of a taxable entity.

**(4)** Heavy construction equipment--Self-propelled, self-powered, or pull-type equipment that weighs at least 3,000 pounds and is intended to be used for construction. The term does not include a motor vehicle required to be titled and registered.

**(5)** Lending institution--An entity that makes loans and:

**(A)** is regulated by the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, the Office of Thrift Supervision, the Texas Department of Banking, the Office of Consumer Credit Commissioner, the Credit Union Department, or any comparable regulatory body;

**(B)** is licensed by, registered with, or otherwise regulated by the Department of Savings and Mortgage Lending;

**(C)** is a "broker" or "dealer" as defined by the Securities Exchange Act of 1934 at 15 U.S.C. § 78c; or

**(D)** provides financing to unrelated parties solely for agricultural production.

**(6)** Principal business activity--The activity in which a taxable entity derives the largest percentage of its "total revenue".

**(7)** Production--Construction, manufacture, installation occurring during the manufacturing or construction process, development, mining, extraction, improvement, creation, raising, or growth.

**(8)** Related party--A person, corporation, or other entity, including an entity that is treated as a pass-through or disregarded entity for purposes of federal taxation, whether the person, corporation, or entity is subject to the tax under this chapter or not, in which one person, corporation, or entity, or set of related persons, corporations, or entities, directly or indirectly owns or controls a controlling interest in another entity.

**(9)** Service costs--Indirect costs and administrative overhead costs that can be identified specifically with a service department or function, or that directly benefit or are incurred by reason of a service department or function. For purposes of this section, a service department includes personnel (including costs of recruiting, hiring, relocating, assigning, and 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.

**(10)** Tangible personal property--

**(A)** includes: (i) personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner; (ii) 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 (iii) a computer program, as defined in paragraph (2) of this subsection.

**(B)** does not include: (i) intangible property or (ii) services.

**(c)** General rules for determining cost of goods sold.

**(1)** Affiliated entities. Notwithstanding any other provision of this section, a payment made by one member of an affiliated group to another member of that affiliated group not included in the combined group may be subtracted as a cost of goods sold only if it is a transaction made at arm's length.

**(2)** Capitalization or expensing of certain costs. The election to capitalize or expense allowable costs is made by filing the franchise tax report using one method or the other. The election is for the entire period on which the report is based and may not be changed after the due date or the date the report is filed, whichever is later. A taxable entity that is allowed a subtraction by this section for a cost of goods sold and that is subject to Internal Revenue Code, §§ 263A, 460, or 471 (including a taxable entity subject to § 471 that elects to use LIFO under § 472), may elect to:

**(A)** Capitalize those costs in the same manner and to the same extent that the taxable entity capitalized those costs on its federal income tax return, except for those costs excluded under subsection (g) of this section, or in accordance with subsections (d), (e), and (f) of this section. A taxable entity that elects to capitalize costs on its first report due on or after January 1, 2008, may include, in beginning inventory, costs allowable for franchise tax purposes that would be in beginning inventory for federal income tax purposes. (i) If the taxable entity elects to capitalize those costs allowed under this section as a cost of goods sold, it must capitalize each cost allowed under this section that it capitalized on its federal income tax return. (ii) If the taxable entity later elects to begin expensing those costs allowed under this section as a cost of goods sold, the entity may not deduct any cost incurred before the first day of the period on which the report is based, including any ending inventory from a previous report.

**(B)** Expense those costs, except for those costs excluded under subsection (g) of this section, or in accordance with subsections (d), (e), and (f) of this section. (i) If the taxable entity elects to expense those costs allowed under this section as a cost of goods sold, costs incurred before the first day of the period on which the report is based may not be subtracted as a cost of goods sold. (ii) If the taxable entity later elects to begin capitalizing those costs allowed under this section as a cost of goods sold, costs incurred prior to the accounting period on which the report is based may not be capitalized.

**(3)** Election to subtract cost of goods sold. A taxable entity, if eligible, must make an annual election to subtract cost of goods sold in computing margin by the due date, or at the time the report is filed, whichever is later. The election to subtract cost of goods sold is made by filing the franchise tax report using the cost of goods sold method. An amended report may be filed within the time allowed by Tax Code, § 111.107 to change the method of computing margin to the cost of goods sold deduction method or from the cost of goods sold deduction method to the compensation deduction method, 70%

of total revenue, or, if otherwise qualified, the E-Z computation method. An election may also be changed as part of an audit. See § 3.584 of this title (relating to Margin: Reports and Payments).

**(4)** Exclusions from total revenue. Any expense excluded from total revenue (see § 3.587 of this title (relating to Margin: Total Revenue)) may not be included in the determination of cost of goods sold.

**(5)** Film and broadcasting. A taxable entity whose principal business activity is film or television production or broadcasting or the sale of broadcast rights or the distribution of tangible personal property described by subsection (b)(10)(A)(ii) of this section, or any combination of these activities, and who elects to use cost of goods sold to determine margin, may include as cost of goods sold:

**(A)** the costs described in this section in relation to the property;

**(B)** depreciation, amortization, and other expenses directly related to the acquisition, production, or use of the property, including

**(C)** expenses for the right to broadcast or use the property.

**(6)** Lending institutions. Notwithstanding any other provision of this section, if the taxable entity is a lending institution that offers loans to the public and elects to subtract cost of goods sold, the entity may subtract as a cost of goods sold an amount equal to interest expense.

**(A)** This paragraph does not apply to entities primarily engaged in an activity described by category 5932 of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget.

**(B)** For purposes of this subsection, an entity engaged in lending to unrelated parties solely for agricultural production offers loans to the public.

**(7)** Mixed transactions. If a transaction contains elements of both a sale of tangible personal property and a service, a taxable entity may only subtract as cost of goods sold the costs otherwise allowed by this section in relation to the tangible personal property sold.

**(8)** 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. The determination of whether a taxable entity is an owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxable entity.

**(A)** A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in § 3.357 of this title (relating to Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance)), of real property is considered to be an owner of the labor or materials and may include the costs, as allowed by this section, in the computation of the cost of goods sold.

**(B)** Solely for the purposes of this section, a taxable entity shall be treated as the owner of goods being manufactured or produced by the entity under a contract with the federal government, including any subcontracts that support a contract with the federal government, notwithstanding that the Federal Acquisition Regulations may require that title or risk of loss with respect to those goods be transferred to the federal government before the manufacture or production of those goods is complete.

**(9)** Rentals and leases. Notwithstanding any other provision of this section, the following taxable entities may 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:

**(A)** a motor vehicle rental company that remits a tax on gross receipts imposed under Tax Code, § 152.026 or a motor vehicle leasing company;

**(B)** a heavy construction equipment rental or leasing company; and

**(C)** a railcar rolling stock rental or leasing company.

**(10)** Reporting methods. A taxable entity shall determine its cost of goods sold, except as otherwise provided by this section, in accordance with the methods used on the federal income tax return on which the report under this chapter is based. This subsection does not affect the type or category of cost of goods sold that may be subtracted under this section.

**(11)** Restaurants and bars. Entities engaged in activities described in Major Group 58 (Eating and Drinking Places) of the Standard Industrial Classification Manual may deduct for cost of goods sold only those expenses allowed under subsections (d), (e) and (f) of this section, that relate to the acquisition and production of food and beverages. Any costs related to both the production of food and beverages and to other activities must be allocated to production on a reasonable basis.

**(d)** Direct costs. The cost of goods sold includes all direct costs of acquiring or producing the goods. Direct costs include:

**(1)** Labor costs. A taxable entity may include in its cost of goods sold calculation labor costs, other than service costs, that are properly allocable to the acquisition or production of goods and are of the type subject to capitalization or allocation under Treasury Regulation Sections 1.263A-1(e) or 1.460-5 as direct labor costs, indirect labor costs, employee benefit expenses, or pension and other related costs, without regard to whether the taxable entity is required to or actually capitalizes such costs for federal income tax purposes.

**(A)** For purposes of this section, labor costs include W-2 wages, IRS Form 1099 payments for labor, temporary labor expenses, payroll taxes, pension contributions, and employee benefits expenses, including, but not limited to, health insurance and per diem reimbursements for travel expenses, to the extent deductible for federal tax purposes.

**(B)** Labor costs under this paragraph shall not include any type of costs includable in subsection (f) or excluded in subsection (g) of this section. Costs for labor that do not meet the requirements set forth in this paragraph may still be subtracted as a cost of goods sold if the cost is allowed under another provision of this section. For example, service costs may be included in a taxable entity's cost of goods sold calculation to the extent provided by subsection (f) of this section.

**(2)** Incorporated materials. A taxable entity may include in its cost of goods sold calculation the cost of materials that are an integral part of specific property produced.

**(3)** Consumable materials. A taxable entity may include in its cost of goods sold calculation the cost of materials that are consumed in the ordinary course of performing production activities.

**(4)** Handling costs. A taxable entity may include in its cost of goods sold calculation handling costs, including costs attributable to processing, assembling, repackaging, and inbound transportation.

**(5)** Storage costs. A taxable entity may include in its cost of goods sold calculation storage costs, including the costs of carrying, storing, or warehousing property, subject to subsection (g) of this section, concerning excluded costs.

**(6)** Depreciation, depletion, and amortization. A taxable entity may include in its cost of goods sold calculation depreciation, depletion, and amortization reported on the federal income tax return on which the report under this chapter is based, to the extent associated with and necessary for the production of goods, including recovery described by Internal Revenue Code, § 197, and property described in Internal Revenue Code, § 179.

**(7)** Rentals and leases. A taxable entity may include in its cost of goods sold calculation the cost of renting or leasing equipment, facilities, or real property directly used for the production of the goods, including pollution control equipment and intangible drilling and dry hole costs.

**(8)** Repair and maintenance. A taxable entity may include in its cost of goods sold calculation the cost of repairing and maintaining equipment, facilities, or real property directly used for the production of the goods, including pollution control devices.

**(9)** Research and development. A taxable entity may include in its cost of goods sold calculation the costs attributable to research, experimental, engineering, and design activities directly related to the production of the goods, including all research or experimental expenditures described by Internal Revenue Code, § 174.

**(10)** Mineral production. A taxable entity may include in its cost of goods sold calculation geological and geophysical costs incurred to identify and locate property that has the potential to produce minerals.

**(11)** Taxes. A taxable entity may include in its cost of goods sold calculation taxes paid in relation to acquiring or producing any material, including property taxes paid on buildings and equipment, and taxes paid in relation to services that are a direct cost of production.

**(12)** Electricity. A taxable entity may include in its cost of goods sold calculation the cost of producing or acquiring electricity sold.

**(13)** A taxable entity may include in its cost of goods sold calculation a contribution to a partnership in which the taxable entity owns an interest that is used to fund activities, the costs of which would otherwise be treated as cost of goods sold of the partnership, but only to the extent that those costs are related to goods distributed to the contributing taxable entity as goods-in-kind in the ordinary course of production activities rather than being sold by the partnership.

**(e)** Additional costs. In addition to the amounts includable under subsection (d) of this section, the cost of goods sold includes the following costs in relation to the taxable entity's goods:

**(1)** deterioration of the goods;

**(2)** obsolescence of the goods;

**(3)** spoilage and abandonment, including the costs of rework, reclamation, and scrap;

**(4)** if the property is held for future production, preproduction direct costs allocable to the property, including storage and handling costs, as provided by subsection (d)(4) and (5) of this section;

**(5)** postproduction direct costs allocable to the property, including storage and handling costs, as provided by subsection (d)(4) and (5) of this section;

**(6)** the cost of insurance on a plant or a facility, machinery, equipment, or materials directly used in the production of the goods;

**(7)** the cost of insurance on the produced goods;

**(8)** the cost of utilities, including electricity, gas, and water, directly used in the production of the goods;

**(9)** the costs of quality control, including replacement of defective components pursuant to standard warranty policies, inspection directly allocable to the production of the goods, and repairs and maintenance of goods; and

**(10)** licensing or franchise costs, including fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right directly associated with the goods produced.

**(f)** Indirect or administrative overhead costs. A taxable entity may subtract as a cost of goods sold service costs, as defined in subsection (b)(9) of this section, that it can demonstrate are reasonably allocable to the acquisition or production of goods. The amount subtracted may not exceed 4.0% of total indirect and administrative overhead costs.

**(1)** Any costs already subtracted under subsections (d) or (e) of this section may not be subtracted under this subsection.

**(2)** Any costs excluded under subsection (g) of this section may not be subtracted under this subsection.

**(g)** Costs not included. The cost of goods sold does not include the following costs in relation to the taxable entity's goods:

**(1)** the cost of renting or leasing equipment, facilities, or real property that is not used for the production of the goods;

**(2)** selling costs, including employee expenses related to sales;

**(3)** distribution costs, including outbound transportation costs;

**(4)** advertising costs;

**(5)** idle facility expenses;

**(6)** rehandling costs;

**(7)** bidding costs, which are the costs incurred in the solicitation of contracts ultimately awarded to the taxable entity;

**(8)** unsuccessful bidding costs, which are the costs incurred in the solicitation of contracts not awarded to the taxable entity;

**(9)** interest, including interest on debt incurred or continued during the production period to finance the production of the goods;

**(10)** income taxes, including local, state, federal, and foreign income taxes, and franchise taxes that are assessed on the taxable entity based on income;

**(11)** strike expenses, including costs associated with hiring employees to replace striking personnel, but not including the wages of the replacement personnel, costs of security, and legal fees associated with settling strikes;

**(12)** officers' compensation;

**(13)** costs of operation of a facility that is:

**(A)** located on property owned or leased by the federal government; and

**(B)** managed or operated primarily to house members of the armed forces of the United States;

**(14)** any compensation paid to an undocumented worker used for the production of goods, provided that, as used in this paragraph only, the following terms shall have the following meanings:

**(A)** "undocumented worker" means a person who is not lawfully entitled to be present and employed in the United States; and

**(B)** "goods" includes the husbandry of animals, the growing and harvesting of crops, and the severance of timber from realty; and

**(15)** costs funded by a partnership contribution, to the extent that the contributing taxable entity made the cost of goods sold deduction under subsection (d)(13) of this section.

## History

**SOURCE:**

The provisions of this § 3.588 adopted to be effective January 1, 2008, 32 TexReg 10034; amended to be effective May 21, 2009, 34 TexReg 2982; amended to be effective June 5, 2013, 38 TexReg 3415; amended to be effective July 13, 2016, 41 TexReg 5073

# 34 TAC § 3.589

This document reflects all regulations in effect as of July 31, 2016

***Texas Administrative Code > TITLE 34. PUBLIC FINANCE > PART 1. COMPTROLLER OF PUBLIC ACCOUNTS > CHAPTER 3. TAX ADMINISTRATION > SUBCHAPTER V. FRANCHISE TAX***

## § 3.589. Margin: Compensation

**(a)** Effective date. The provisions of this section apply to franchise tax reports originally due on or after January 1, 2008, except as otherwise noted.

**(b)** Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

**(1)** Assigned employee--Has the meaning assigned by Labor Code, § 91.001.

**(2)** Client company--

**(A)** a person that contracts with a license holder under Labor Code, Chapter 91, and is assigned employees by the license holder under that contract; or

**(B)** a client of a temporary employment service, as that term is defined by Labor Code, § 93.001(2), to whom individuals are assigned for a purpose described by that subdivision.

**(3)** Management company--A corporation, limited liability company or other limited liability entity that conducts all or part of the active trade or business of another entity (the managed entity) in exchange for a management fee and reimbursement of specified costs incurred in the conduct of the active trade or business of the managed entity, including wages and cash compensation as determined under Tax Code, § 171.1013(a) and (b). To qualify as a management company:

**(A)** the entity must perform active and substantial management and operational functions, control and direct the daily operations and provide services such as accounting, general administration, legal, financial or similar services; or

**(B)** if the entity does not conduct all of the active trade or business of an entity, the entity must conduct all operations, as provided in subparagraph (A) of this paragraph, for a distinct revenue-producing component of the entity.

**(4)** Natural person--A human being or the estate of a human being. The term does not include a purely legal entity given recognition as the possessor of rights, privileges, or responsibilities, such as a corporation, limited liability company, partnership, or trust.

**(5)** Net distributive income--The net amount of income, gain, deduction, or loss relating to a pass-through entity or disregarded entity reportable to the owners for the tax year of the entity.

**(6)** Small employer--An entity defined in Insurance Code, § 1501.002.

**(7)** Staff leasing services company--A business entity that offers staff leasing services as that term is defined by Labor Code, § 91.001, or temporary employment service as that term is defined by Labor Code, § 93.001.

**(8)** Undocumented worker--A person who is not lawfully entitled to be present and employed in the United States.

**(9)** Wages and cash compensation--

**(A)** the amount entered in the Medicare wages and tips box of Internal Revenue Service Form W-2 or any subsequent form with a different number or designation that substantially provides the same information for the period on which the tax is based;

**(B)** the amount of net distributive income (not to include net distributive income that has been subtracted from total revenue), regardless of whether cash or property pertaining to such income is actually distributed and regardless of whether it is a positive or negative amount, from one of the following entities to partners or owners during the accounting period but only if the person receiving the amount is a natural person: (i) taxable entities treated as partnerships for federal income tax purposes; (ii) limited liability companies and corporations treated as S corporations for federal income tax purposes; and (iii) limited liability companies treated as sole proprietorships for federal income tax purposes;

**(C)** stock awards and stock options deducted for federal income tax purposes, to the extent not included in subparagraph (A) of this paragraph.

**(c)** Compensation. Subject to Tax Code, § 171.1014, a taxable entity that elects to subtract compensation (see subsection (i) in this section) for the purpose of computing its taxable margin under Tax Code, § 171.101, may subtract an amount equal to:

**(1)** subject to subsection (d) of this section, all wages and cash compensation paid by a taxable entity to its officers, directors, owners, partners and employees.

**(A)** For reports originally due on or after January 1, 2008 but before January 1, 2010, the taxable entity cannot subtract more than $ 300,000 per 12-month period on which the tax is based for any one person in wages and cash compensation it determines under Tax Code, § 171.1013. See § 3.590 of this title (relating to Margin: Combined Reporting).

**(B)** For reports originally due on or after January 1, 2010, the taxable entity cannot subtract more than $ 320,000 (determined under Tax Code, § 171.006) per 12-month period on which the tax is based for any one person in wages and cash compensation it determines under Tax Code, § 171.1013. See § 3.590 of this title; and

**(2)** subject to subsection (e) of this section, the cost of all benefits the taxable entity provides to its officers, directors, owners, partners, and employees;

**(d)** Compensation - excluded items. Compensation does not include:

**(1)** payments made that are reportable on Internal Revenue Form 1099 (or would have been reported if the amount had met the Internal Revenue Service minimum reporting requirement);

**(2)** any expense excluded from total revenue and any net distributive income subtracted from total revenue. See § 3.587 of this title (relating to Margin: Total Revenue);

**(3)** an employer's share of payroll taxes;

**(4)** wages or cash compensation paid to an employee whose primary employment is directly associated with the operation of a facility that is located on property owned or leased by the federal government, and managed or operated primarily to house members of the armed forces of the United States. See § 3.587 of this title; and

**(5)** wages or cash compensation paid to undocumented workers.

**(e)** Benefits. A taxable entity is allowed to subtract the cost of all benefits to the extent deductible for federal income tax purposes that it provides to its officers, directors, owners, partners, and employees.

**(1)** The term "benefits" includes employer contributions made to:

**(A)** employees' health savings accounts;

**(B)** health care (for example, this would include contributions to the cost of health insurance);

**(C)** retirement; and

**(D)** workers' compensation.

**(2)** The term "benefits" does not include the following:

**(A)** amounts included in the definition of wages and cash compensation;

**(B)** discounts on the price of the taxable entity's merchandise or services sold to the taxpayer's employees, officers, or directors, partners, or owners that are not available to other customers;

**(C)** payroll taxes. (For example, "payroll taxes" would include payments to state and federal unemployment compensation funds and payments under the Federal Insurance Contributions Act, Chapter 21 of Subtitle C of the Internal Revenue Code, §§ 3101 - 3128, the Railroad Retirement Tax Act, Chapter 22 of Subtitle C of the Internal Revenue Code, §§ 3201 - 3233); and

**(D)** working condition amounts provided so employees can perform their jobs. (Examples of working condition benefits include an employee's use of a company car for business, job-related education provided to an employee, and travel reimbursement.)

**(3)** The cost of benefits does not include the amount paid by an employee.

**(f)** Staff leasing companies. See § 3.587 of this title.

**(1)** A staff leasing company cannot include as compensation the following payments for assigned employees:

**(A)** wages and cash compensation;

**(B)** payroll taxes;

**(C)** employee benefits including workers' compensation; and

**(D)** payments made to independent contractors and reportable on Internal Revenue Service Form 1099 (or would have been reported if the amount had met the Internal Revenue Service minimum reporting requirement).

**(2)** A client company can include as compensation the following amounts for assigned employees:

**(A)** wages and cash compensation; and

**(B)** benefits.

**(3)** A client company cannot include as compensation the following:

**(A)** an administrative fee;

**(B)** payments made to a staff leasing company as reimbursement for payments made to independent contractors assigned to the client company and reportable on Internal Revenue Service Form 1099 (or would have been reported if the amount had met the Internal Revenue Service minimum reporting requirement); and

**(C)** other costs.

**(4)** A staff leasing company shall determine compensation only for the taxable entity's own employees who are not assigned employees.

**(g)** Management company. See § 3.587 of this title.

**(1)** A taxable entity that is a management company may not include as wages and cash compensation any amounts reimbursed by a managed entity.

**(2)** A taxable entity that is a managed entity may subtract wages and cash compensation that are reimbursed to the management company.

**(3)** A management company shall determine compensation for only those wages and compensation payments that are not reimbursed by a managed entity.

**(h)** Small employers. This subsection applies to a taxable entity that is a small employer and that has not provided health care benefits to any of its employees in the calendar year preceding the beginning date of its reporting period. Subject to Tax Code, § 171.1014, a taxable entity to which this subsection applies that elects to subtract compensation for the purpose of computing its taxable margin under Tax Code, § 171.101, may subtract the following health care benefits:

**(1)** amounts as provided under subsection (c) of this section;

**(2)** for the first 12-month period on which margin is based and in which the taxable entity provides health care benefits to all of its employees, an additional amount equal to 50% of the cost of health care benefits provided to its employees for that period; and

**(3)** for the second 12-month period on which margin is based and in which the taxable entity provides health care benefits to all of its employees, an additional amount equal to 25% of the cost of health care benefits provided to its employees for that period.

**(4)** The term "provide" does not include amounts paid by the employee, officer, director, etc.

**(i)** Election to subtract compensation. A taxable entity must make an annual election to subtract compensation in computing margin by the due date or at the time the report is filed, whichever is later. The election to subtract compensation is made by filing the franchise tax report using the compensation method.

**(1)** After the due date of the report, an amended report may not be filed to change the method of computing margin from the compensation deduction to the cost of goods sold deduction.

**(2)** An amended report may be filed to change the method of computing margin from the compensation deduction to 70% of total revenue or, if qualified, the E-Z Computation.

## History

**SOURCE:**

The provisions of this § 3.589 adopted to be effective January 1, 2008, 32 TexReg 10038; amended to be effective January 1, 2009, 33 TexReg 10504; amended to be effective December 31, 2009, 34 TexReg 9471

TEXAS ADMINISTRATIVE CODE

# 34 TAC § 3.599

This document reflects all regulations in effect as of July 31, 2016

***Texas Administrative Code > TITLE 34. PUBLIC FINANCE > PART 1. COMPTROLLER OF PUBLIC ACCOUNTS > CHAPTER 3. TAX ADMINISTRATION > SUBCHAPTER V. FRANCHISE TAX***

## § 3.599. Margin: Research and Development Activities Credit

**(a)** Effective dates.

**(1)** The provisions of this section apply to franchise tax reports originally due on or after January 1, 2014.

**(2)** These provisions expire on December 31, 2026. The credits allowed under this section cannot be established on a report originally due after December 31, 2026. The expiration does not affect the carryforward of a credit authorized under these provisions as provided in subsection (j) of this section and established on a report originally due prior to the expiration date of these provisions.

**(b)** Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

**(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.

**(3)** Controlling interest--

**(A)** For a corporation, either more than 50%, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50% owned directly or indirectly, of the beneficial ownership interest in the voting stock of the corporation.

**(B)** For a partnership, association, trust, or other entity other than a limited liability company, more than 50%, owned directly or indirectly, of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity.

**(C)** For a limited liability company, either more than 50%, owned directly or indirectly, of the total membership interest of the limited liability company or more than 50%, owned directly or indirectly, of the beneficial ownership interest in the membership interest of the limited liability company.

**(4)** Internal Revenue Code--The Internal Revenue Code of 1986 in effect on December 31, 2011, excluding any changes made by federal law after that date, but including any regulations that are later adopted under that code applicable to the tax year to which the provisions of the code in effect on that date applied.

**(5)** Public or private institution of higher education--

**(A)** an institution of higher education, as defined by Education Code, § 61.003; or

**(B)** a private or independent institution of higher education, as defined by Education Code, § 61.003.

**(6)** Qualified research--This term has the meaning given in Internal Revenue Code, § 41(d), except that the research must be conducted in Texas.

**(7)** Qualified research expense--This term has the meaning given in Internal Revenue Code, § 41(b), except that the expense must be for qualified research conducted in Texas.

**(8)** Registration Number--The number issued by the comptroller to a person who submits the Texas Registration for Qualified Research and Development Sales Tax Exemption form.

**(9)** Research and development activities credit--A credit against franchise tax for qualified research expenses that is allowed under Tax Code, Chapter 171, Subchapter M.

**(10)** Research and development credit--A credit against franchise tax for research and development expenses allowed under Tax Code, Chapter 171, Subchapter O, and established on a franchise tax report originally due prior to January 1, 2008.

**(11)** Tax period--The period on which a franchise tax report is based as provided by § 3.584(c) of this title (relating to Margin: Reports and Payments).

**(c)** Eligibility for credit. A taxable entity is eligible to claim a research and development activities credit for the periods in which the taxable entity is engaged in qualified research and incurs qualified research expenses. The credit may be claimed on a franchise tax report for qualified research expenses incurred during the period on which the report is based.

**(d)** Ineligibility for credit.

**(1)** A taxable entity is not eligible to claim a credit on a franchise tax report for qualified research expenses incurred during the period on which the report is based if the taxable entity, or a member of the combined group, if the taxable entity is a combined group, received an exemption from sales and use tax under Tax Code, § 151.3182 during that period.

**(2)** A taxable entity's ineligibility under this subsection does not affect the taxable entity's eligibility to claim a carryforward of unused credit under subsection (j) of this section.

**(e)** Amount of credit.

**(1)** Qualified research expenses in Texas. Subject to subsection (f) of this section, and except as provided by paragraphs (2), (3), and (4) of this subsection, the credit allowed for any report equals 5.0% of the difference between:

**(A)** the qualified research expenses incurred during the period on which the report is based; and

**(B)** 50% of the average amount of qualified research expenses incurred during the three tax periods preceding the period on which the report is based.

**(2)** Entities without qualified research expenses in each of the three preceding tax periods. Except as provided by paragraph (4) of this subsection, if the taxable entity has no qualified research expenses in one or more of the three tax periods preceding the period on which the report is based, the credit for the period on which the report is based equals 2.5% of the qualified research expenses incurred during that period.

**(3)** Qualified research expenses under a higher education contract. Subject to subsection (f) of this section, and except as provided by paragraph (4) of this subsection, if the taxable entity contracts with one or more public or private institutions of higher education for the performance of qualified research and the taxable entity incurs qualified research expenses in this state under the contract during the period on which the report is based, then the credit for the report equals 6.25% of the difference between:

**(A)** all qualified research expenses incurred during the period on which the report is based; and

**(B)** 50% of the average amount of all qualified research expenses incurred during the three tax periods preceding the period on which the report is based.

**(4)** Entities with qualified research expenses under higher education contracts but without qualified research expenses in each of the three preceding tax periods. If the taxable entity incurs qualified research expenses in Texas under a contract with one or more public or private institutions of higher education for the performance of qualified research during the period on which the report is based, but the taxable entity has no qualified research expenses in one or more of the three tax periods preceding the period on which the report is based, then the credit for the period on which the report is based equals 3.125% of all qualified research expenses incurred during that period.

**(5)** Same method of computing qualified research expenses required. Notwithstanding whether the statute of limitations for claiming a credit under this section has expired for any tax period used in determining the average amount of qualified research expenses under paragraph (1)(B) or (3)(B) of this subsection, the determination of which research expenses are qualified research expenses for purposes of computing that average must be made in the same manner as that determination is made for purposes of paragraph (1)(A) or (3)(A) of this subsection.

**(f)** Attribution of expenses following transfer of controlling interest.

**(1)** If a taxable entity acquires a controlling interest in another taxable entity, or in a separate unit of another taxable entity, during a tax period with respect to which the acquiring taxable entity claims a credit under this section, then the amount of the acquiring taxable entity's qualified research expenses equals the sum of:

**(A)** the amount of qualified research expenses incurred by the acquiring taxable entity during the period on which the report is based; and

**(B)** subject to paragraph (4) of this subsection, the amount of qualified research expenses incurred by the acquired taxable entity or unit during the portion of the period on which the report is based that precedes the date of the acquisition.

**(2)** A taxable entity that sells or otherwise transfers to another taxable entity a controlling interest in another taxable entity, or in a separate unit of a taxable entity, during a period on which a report is based may not claim a credit under this section for qualified research expenses incurred by the transferred taxable entity or unit during the period if:

**(A)** the taxable entity that makes the sale or transfer is ineligible for the credit under subsection (d) of this section; or

**(B)** the acquiring taxable entity claims a credit under this section for the corresponding period.

**(3)** If during any of the three tax periods following the period in which a sale or other transfer described by paragraph (2) of this subsection occurs, the taxable entity that sold or otherwise transferred the controlling interest reimburses the acquiring taxable entity for research activities conducted on behalf of the taxable entity that made the sale or other transfer, the amount of the reimbursement is:

**(A)** included as qualified research expenses incurred by the taxable entity that made the sale or other transfer for the tax period during which the reimbursement was paid, subject to paragraph (5) of this subsection; and

**(B)** excluded from the qualified research expenses incurred by the acquiring taxable entity for the tax period during which the reimbursement was paid.

**(4)** An acquiring taxable entity may not include on a report the amount of qualified research expenses otherwise authorized by paragraph (1)(B) of this subsection if the taxable entity that made the sale or other transfer described by paragraph (2) of this subsection received an exemption under Tax Code, § 151.3182 during the portion of the period on which the acquiring taxable entity's report is based that precedes the date of the acquisition.

**(5)** A taxable entity that makes a sale or other transfer described by paragraph (2) of this subsection may not include on a report the amount of reimbursement otherwise authorized by paragraph (3)(A) of this subsection if the reimbursement is for research activities that occurred during a tax period in which the entity that makes a sale or other transfer received an exemption under Tax Code, § 151.3182.

**(g)** Combined reporting. A credit under this section for qualified research expenses incurred by a member of a combined group must be claimed on the combined report for the group required by Tax Code, § 171.1014 (Combined Reporting; Affiliated Group Engaged in Unitary Business). The combined group is the taxable entity for purposes of this section.

**(h)** Tiered partnership reporting.

**(1)** An upper tier entity and a lower tier entity may claim a credit under this section for qualified research expenses; however, an upper tier entity and a lower tier entity cannot claim a credit under this section for the same qualified research expense.

**(2)** An upper tier entity that includes the total revenue of a lower tier entity for purposes of computing its taxable margin as authorized by Tax Code, § 171.1015 may claim the credit under this section for qualified research expenses incurred by the lower tier entity to the extent of the upper tier entity's ownership interest in the lower tier entity.

**(i)** Limitation. The total credit claimed under this section for a report, including the amount of any carryforward credit under subsection (j) of this section, may not exceed 50% of the amount of franchise tax due for the report before any other applicable tax credits.

**(j)** Carryforward.

**(1)** If a taxable entity is eligible for a credit that exceeds the limitation under subsection (i) of this section, the taxable entity may carry the unused credit forward for not more than 20 consecutive reports.

**(2)** Credits, including credit carryforwards, are considered to be used in the following order:

**(A)** a credit carryforward of unused research and development credits accrued under Tax Code, Chapter 171, Subchapter O, before its repeal on January 1, 2008, and claimed as authorized by § 3.593 of this title (relating to Margin: Franchise Tax Credits);

**(B)** a credit carryforward under this section; and

**(C)** a current year credit.

**(k)** Assignment prohibited. A taxable entity may not convey, assign, or transfer the credit allowed under this section to another entity unless all of the assets of the taxable entity are conveyed, assigned, or transferred in the same transaction.

**(l)** Application for credit.

**(1)** A taxable entity must apply for a credit under this section. A taxable entity applies for the credit by claiming the credit on or with the franchise tax report for the period for which the credit is claimed. To apply for a credit, a taxable entity must also complete Form 05-178, Texas Franchise Tax Research and Development Activities Credits Schedule, its electronic equivalent, or any form promulgated by the comptroller that succeeds such form.

**(2)** The comptroller may require a taxable entity that claims a credit under this section to provide all data and information required for the comptroller to evaluate the credit and to comply with Tax Code, § 151.3182(c).

**(m)** Amending reports.

**(1)** If a report was originally due and filed after the effective date of this section and a credit allowed under this section was not claimed, a taxable entity may file an amended report within the statute of limitation to claim a credit, if the taxable entity or a member of its combined group does not have an active Registration Number for that period. See § 3.584 of this title for information about filing an amended report.

**(2)** If a taxable entity or member of the combined group has or had a Registration Number for a period it intends to claim a credit allowed under this section, the taxable entity or member of the combined group must submit a written request to cancel the registration before claiming a credit with the following information:

**(A)** the tax period(s) covered by the report which it intends to claim a credit allowed under this section; and

**(B)** a statement whether tax-exempt purchases were made. If tax-exempt purchases were made, include an original or amended sales and use tax report with tax due, penalty, and interest for the sales tax periods that cover the tax-exempt purchases.

**(3)** If a report was filed claiming a credit allowed under this section and the taxable entity later decides to claim a sales and use tax exemption under Tax Code § 151.3182, the taxable entity must:

**(A)** file an amended report that does not claim the credit under this section and pay any tax, penalty, and interest due;

**(B)** apply for a Registration Number; and

**(C)** file a request for a sales and use tax refund for taxes paid on purchases under Tax Code, § 151.3182.

## History

**SOURCE:**

The provisions of this § 3.599 adopted to be effective April 5, 2015, 40 TexReg 1858

TEXAS ADMINISTRATIVE CODE

# Tex. Gov’t Code § 311.023

This document is current through the 2015 regular session, 84th Legislature.

***Texas Statutes & Codes Annotated by LexisNexis® > Government Code > Title 3 Legislative Branch > Subtitle B Legislation > Chapter 311 Code Construction Act > Subchapter C Construction of Statutes***

## Sec. 311.023. Statute Construction Aids.

In construing a statute, whether or not the statute is considered ambiguous on its face, a court may consider among other matters the:

**(1)** object sought to be attained;

**(2)** circumstances under which the statute was enacted;

**(3)** legislative history;

**(4)** common law or former statutory provisions, including laws on the same or similar subjects;

**(5)** consequences of a particular construction;

**(6)** administrative construction of the statute; and

**(7)** title (caption), preamble, and emergency provision.

## History

Enacted by Acts 1985, 69th Leg., ch. 479 (S.B. 813), § 1, effective September 1, 1985.

# Tex. R. App. P. Rule 9

This document is current through July 20, 2016

***Texas Court Rules > STATE RULES > TEXAS RULES OF APPELLATE PROCEDURE > SECTION ONE. GENERAL PROVISIONS***

## Rule 9 Documents Generally

**9.1.** ***Signing.***

**(a)** ***Represented Parties.***--If a party is represented by counsel, a document filed on that party's behalf must be signed by at least one of the party's attorneys. For each attorney whose name appears on a document as representing that party, the document must contain that attorney's State Bar of Texas identification number, mailing address, telephone number, fax number, if any, and email address.

**(b)** ***Unrepresented Parties.***--A party not represented by counsel must sign any document that the party files and give the party's mailing address, telephone number, and fax number, if any, and email address.

**(c)** ***Electronic Signatures.***--A document that is electronically served, filed, or issued by a court or clerk is considered signed if the document includes:

**(1)** a "/s/" and name typed in the space where the signature would otherwise appear, unless the document is notarized or sworn; or

**(2)** an electronic image or scanned image of the signature.

**9.2.** ***Filing.***

**(a)** ***With Whom.***--A document is filed in an appellate court by delivering it to:

**(1)** the clerk of the court in which the document is to be filed; or

**(2)** a justice or judge of that court who is willing to accept delivery. A justice or judge who accepts delivery must note on the document the date and time of delivery, which will be considered the time of filing, and must promptly send it to the clerk.

**(b)** ***Filing by Mail.***

**(1)** ***Timely Filing.***--A document received within ten days after the filing deadline is considered timely filed if:

**(A)** it was sent to the proper clerk by United States Postal Service or a commercial delivery service;

**(B)** it was placed in an envelope or wrapper properly addressed and stamped; and

**(C)** it was deposited in the mail or delivered to a commercial delivery service on or before the last day for filing.

**(2)** ***Proof of Mailing.***--Though it may consider other proof, the appellate court will accept the following as conclusive proof of the date of mailing:

**(A)** a legible postmark affixed by the United States Postal Service;

**(B)** a receipt for registered or certified mail if the receipt is endorsed by the United States Postal Service;

**(C)** a certificate of mailing by the United States Postal Service; or

**(D)** a receipt endorsed by the commercial delivery service.

**(c)** ***Electronic Filing.***

**(1)** ***Requirement.***--Attorneys in civil cases must electronically file documents. Attorneys in criminal cases must electronically file documents except for good cause shown in a motion filed in the appellate court. Unrepresented parties in civil and criminal cases may electronically file documents, but it is not required.

**(2)** ***Mechanism.***--Electronic filing must be done through the electronic filing manager established by the Office of Court Administration and an electronic filing service provider certified by the Office of Court Administration.

**(3)** ***Exceptions.***--Documents filed under seal, subject to a pending motion to seal, or to which access is otherwise restricted by law or court order must not be electronically filed. For good cause, an appellate court may permit a party to file other documents in paper form in a particular case.

**(4)** ***Timely Filing.***--Unless a document must be filed by a certain time of day, a document is considered timely filed if it is electronically filed at any time before midnight (in the court's time zone) on the filing deadline. An electronically filed document is deemed filed when transmitted to the filing party's electronic filing service provider, except:

**(A)** if a document is transmitted on a Saturday, Sunday, or legal holiday, it is deemed filed on the next day that is not a Saturday, Sunday, or legal holiday; and

**(B)** if a document requires a motion and an order allowing its filing, the document is deemed filed on the date the motion is granted.

**(5)** ***Technical Failure.***--If a document is untimely due to a technical failure or a system outage, the filing party may seek appropriate relief from the court.

**(6)** ***Confirmation of Filing.***--The electronic filing manager will send a filing confirmation notice to the filing party.

**(7)** ***Electronic Notices From the Court.***--The clerk may send notices, orders, or other communications about the case to the party electronically. A court seal may be electronic.

**9.3.** ***Number of Copies.***

**(a)** ***Courts of Appeals.***

**(1)** ***Document Filed in Paper Form.***--If a document is not electronically filed, a party must file the original and one unbound copy of the document unless otherwise required by local rule. The unbound copy of an appendix must contain a separate page before each document and must not include tabs that extend beyond the edge of the page.

**(2)** ***Electronically Filed Document.***--Unless required by local rule, a party need not file a paper copy of an electronically filed document.

**(b)** ***Supreme Court and Court of Criminal Appeals.***

**(1)** ***Document Filed in Paper Form.***--If a document is not electronically filed, a party must file the original and 11 copies of any document addressed to either the Supreme Court or the Court of Criminal Appeals, except that in the Supreme Court only an original and one copy must be filed of any motion, response to the motion, and reply in support of the motion, and in the Court of Criminal Appeals, only the original must be filed of a motion for extension of time or a response to the motion, or a pleading under Code of Criminal Procedure article 11.07.

**(2)** ***Electronically Filed Document.***--Paper copies of each document that is electronically filed with the Supreme Court or the Court of Criminal Appeals must be mailed or hand-delivered to the Supreme Court or the Court of Criminal Appeals, as appropriate, within three business days after the document is electronically filed. The number of paper copies required shall be determined, respectively, by order of the Supreme Court or the Court of Criminal Appeals.

**(c)** ***Exception for Record.***--Only the original record need be filed in any proceeding.

**9.4.** ***Form.***--Except for the record, a document filed with an appellate court, including a paper copy of an electronically filed document, must - unless the court accepts another form in the interest of justice - be in the following form:

**(a)** ***Printing.***--A document may be produced by standard typographic printing or by any duplicating process that produces a distinct black image. Printing must be on one side of the paper.

**(b)** ***Paper Type and Size.***--The paper on which a document is produced must be 81/2 by 11 inches, white or nearly white, and opaque.

**(c)** ***Margins.***--Documents must have at least one-inch margins on both sides and at the top and bottom.

**(d)** ***Spacing.***--Text must be double-spaced, but footnotes, block quotations, short lists, and issues or points of error may be single-spaced.

**(e)** ***Typeface.***--A document produced on a computer must be printed in a conventional typeface no smaller than 14-point except for footnotes, which must be no smaller than 12-point. A typewritten document must be printed in standard 10-character-per-inch (cpi) monospaced typeface.

**(f)** ***Binding and Covering.***--A paper document must be bound so as to ensure that it will not lose its cover or fall apart in regular use. A paper document should be stapled once in the top left-hand comer or be bound so that it will lie flat when open. A paper petition or brief should have durable front and back covers which must not be plastic or be red, black, or dark blue.

**(g)** ***Contents of Cover.***--A document's front cover, if any, must contain the case style, the case number, the title of the document being filed, the name of the party filing the document, and the name, mailing address, telephone number, fax number, if any, email address, and State Bar of Texas identification number of the lead counsel for the filing party. If a party requests oral argument in the court of appeals, the request must appear on the front cover of that party's first brief.

**(h)** ***Appendix and Original Proceeding Record.***--A paper appendix may be bound either with the document to which it is related or separately. If separately bound, the appendix must comply with paragraph (f). A paper record in an original proceeding or a paper appendix must be tabbed and indexed. An electronically filed record in an original proceeding or an electronically filed appendix that includes more than one item must contain bookmarks to assist in locating each item.

**(i)** ***Length.***

**(1)** ***Contents Included and Excluded.***--In calculating the length of a document, every word and every part of the document, including headings, footnotes, and quotations, must be counted except the following: caption, identity of parties and counsel, statement regarding oral argument, table of contents, index of authorities, statement of the case, statement of issues presented, statement of jurisdiction, statement of procedural history, signature, proof of service, certification, certificate of compliance, and appendix.

**(2)** ***Maximum Length.***--The documents listed below must not exceed the following limits:

**(A)** A brief and response in a direct appeal to the Court of Criminal Appeals in a case in which the death penalty has been assessed: 37,500 words if computer-generated, and 125 pages if not.

**(B)** A brief and response in an appellate court (other than a brief under subparagraph (A)) and a petition and response in an original proceeding in the court of appeals: 15,000 words if computer generated, and 50 pages if not. In a civil case in the court of appeals, the aggregate of all briefs filed by a party must not exceed 27,000 words if computer-generated, and 90 pages if not.

**(C)** A reply brief in an appellate court and a reply to a response to a petition in an original proceeding in the court of appeals: 7,500 words if computer-generated, and 25 pages if not.

**(D)** A petition and response in an original proceeding in the Supreme Court, a petition for review and response in the Supreme Court, a petition for discretionary review in the Court of Criminal

Appeals, and a motion for rehearing and response in an appellate court: 4,500 words if computer-generated, and 15 pages if not.

**(E)** A reply to a response to a petition for review in the Supreme Court, a reply to a response to a petition in an original proceeding in the Supreme Court, and a reply to a petition for discretionary review in the Court of Criminal Appeals: 2,400 words if computer-generated, and 8 pages if not.

**(3)** ***Certificate of Compliance.***--A computer-generated document that is subject to a word limit under this rule must include a certificate by counsel or an unrepresented party stating the number of words in the document. The person certifying may rely on the word count of the computer program used to prepare the document.

**(4)** ***Extensions.***--A court may, on motion, permit a document that exceeds the prescribed limit.

**(j)** ***Electronically Filed Documents.***--An electronically filed document must:

**(1)** be in text-searchable portable document format (PDF);

**(2)** be directly converted to PDF rather than scanned, if possible;

**(3)** not be locked;

**(4)** be combined with any appendix into one computer file, unless that file would exceed the size limit prescribed by the electronic filing manager; and

**(5)** otherwise comply with the Technology Standards set by the Judicial Committee on Information Technology and approved by the Supreme Court.

**(k)** ***Nonconforming Documents.***--If a document fails to conform with these rules, the court may strike the document or identify the error and permit the party to resubmit the document in a conforming format by a specified deadline.

**9.5.** ***Service.***

**(a)** ***Service of All Documents Required.***--At or before the time of a document's filing, the filing party must serve a copy on all parties to the proceeding. Service on a party represented by counsel must be made on that party's lead counsel. Except in original proceedings, a party need not serve a copy of the record.

**(b)** ***Manner of Service.***

**(1)** ***Documents Filed Electronically.***--A document filed electronically under Rule 9.2 must be served electronically through the electronic filing manager if the email address of the party or attorney to be served is on file with the electronic filing manager. If the email address of the party or attorney to be served is not on file with the electronic filing manager, the document may be served on that party or attorney under subparagraph (2).

**(2)** ***Documents Not Filed Electronically.***--A document that is not filed electronically may be served in person, by mail, by commercial delivery service, by fax, or by email. Personal service includes delivery to any responsible person at the office of the lead counsel for the party served.

**(c)** ***When Complete.***

**(1)** Service by mail is complete on mailing.

**(2)** Service by commercial delivery service is complete when the document is placed in the control of the delivery service.

(3) Service by fax is complete on receipt.

**(4)** Electronic service is complete on transmission of the document to the serving party's electronic filing service provider. The electronic filing manager will send confirmation of service to the serving party.

**(d)** ***Proof of Service.***--A document presented for filing must contain a proof of service in the form of either an acknowledgment of service by the person served or a certificate of service. Proof of service may appear on or be affixed to the filed document. The clerk may permit a document to be filed without proof of service, but will require the proof to be filed promptly.

**(e)** ***Certificate Requirements.***--A certificate of service must be signed by the person who made the service and must state:

**(1)** the date and manner of service;

**(2)** the name and address of each person served; and

**(3)** if the person served is a party's attorney, the name of the party represented by that attorney.

**9.6.** ***Communications with the Court.***--Parties and counsel may communicate with the appellate court about a case only through the clerk.

**9.7.** ***Adoption by Reference.***--Any party may join in or adopt by reference all or any part of a brief, petition, response, motion, or other document filed in an appellate court by another party in the same case.

**9.8.** ***Protection of Minor's Identity in Parental-Rights Termination Cases and Juvenile Court Cases.***

**(a)** ***Alias Defined.***--For purposes of this rule, an alias means one or more of a person's initials or a fictitious name, used to refer to the person.

**(b)** ***Parental-Rights Termination Cases.***--In an appeal or an original proceeding in an appellate court, arising out of a case in which the termination of parental rights was at issue:

**(1)** except for a docketing statement, in all papers submitted to the court, including all appendix items submitted with a brief, petition, or motion:

**(A)** a minor must be identified only by an alias unless the court orders otherwise;

**(B)** the court may order that a minor's parent or other family member be identified only by an alias if necessary to protect a minor's identity; and

**(C)** all documents must be redacted accordingly;

**(2)** the court must, in its opinion, use an alias to refer to a minor, and if necessary to protect the minor's identity, to the minor's parent or other family member.

**(c)** ***Juvenile Court Cases.***--In an appeal or an original proceeding in an appellate court, arising out of a case under Title 3 of the Family Code:

**(1)** except for a docketing statement, in all papers submitted to the court, including all appendix items submitted with a brief, petition, or motion:

**(A)** a minor must be identified only by an alias;

**(B)** a minor's parent or other family member must be identified only by an alias; and

**(C)** all documents must be redacted accordingly;

**(2)** the court must, in its opinion, use an alias to refer to a minor and to the minor's parent or other family member.

**(d)** ***No Alteration of Appellate Record.***--Nothing in this rule permits alteration of the original appellate record except as specifically authorized by court order.

**9.9.** ***Privacy Protection for Documents Filed in Civil Cases.***

**(a)** ***Sensitive Data Defined.***--Sensitive data consists of:

**(1)** a driver's license number, passport number, social security number, tax identification number or similar government-issued personal identification number;

**(2)** a bank account number, credit card number, or other financial account number; and

**(3)** a birth date, home address, and the name of any person who was a minor when the underlying suit was filed.

**(b)** ***Filing of Documents Containing Sensitive Data Prohibited.***--Unless the inclusion of sensitive data is specifically required by a statute, court rule, or administrative regulation, an electronic or paper document containing sensitive data may not be filed with a court unless the sensitive data is redacted, except for the record in an appeal under Section Two.

**(c)** ***Redaction of Sensitive Data; Retention Requirement.***--Sensitive data must be redacted by using the letter "X" in place of each omitted digit or character or by removing the sensitive data in a manner indicating that the data has been redacted. The filing party must retain an unredacted version of the filed document during the pendency of the appeal and any related proceedings filed within six months of the date the judgment is signed.

**(d)** ***Notice to Clerk.***--If a document must contain sensitive data, the filing party must notify the clerk by:

**(1)** designating the document as containing sensitive data when the document is electronically filed; or

**(2)** if the document is not electronically filed, by including, on the upper left- hand side of the first page, the phrase: "NOTICE: THIS DOCUMENT CONTAINS SENSITIVE DATA."

**(e)** ***Restriction on Remote Access.***--Documents that contain unredacted sensitive data in violation of this rule must not be posted on the Internet.

**9.10.** ***Privacy Protection for Documents Filed in Criminal Cases***

**(a)** ***Sensitive Data Defined.***--Sensitive data consists of:

**(1)** a driver's license number, passport number, social security number, tax identification number or similar government-issued personal identification number;

**(2)** bank account number, credit card number, and other financial account number;

**(3)** a birth date, a home address, and the name of any person who was a minor at the time the offense was committed.

**(b)** ***Redacted Filings.***--Unless a court orders otherwise, an electronic or paper filing with the court, including the contents of any appendices, must not contain sensitive data.

**(c)** ***Exemptions from the Redaction Requirement.***--The redaction requirement does not apply to the following:

**(1)** A court filing that is related to a criminal matter or investigation and that is prepared before the filing of a criminal charge or is not filed as part of any docketed criminal case;

**(2)** An arrest or search warrant;

**(3)** A charging document and an affidavit filed in support of any charging document;

**(4)** A defendant's date of birth;

**(5)** A defendant's address; and

**(6)** Any government issued number intended to identify the defendant associated with a criminal filing, except for the defendant's social security number or driver's license number.

**(d)** ***Redaction procedures.***--Sensitive data must be redacted by using the letter "X" in place of each omitted digit or character or by removing the sensitive data in a manner indicating that the data has been redacted. The filer must retain an unredacted version of the filed document during the pendency of the appeal and any related proceedings filed within three years of the date the judgment is signed. If a district court clerk or appellate court clerk discovers unredacted sensitive data in the record, the clerk shall notify the parties and seek a ruling from the court.

**(e)** ***Certification.***--The filing of a document constitutes a certification by the filer that the document complies with paragraphs (a) and (b) of this rule.

**(f)** ***Reference List.***--If a filer believes any information described in paragraph (a) of this rule is essential to a document or that the document would be confusing without the information, the filer may submit the information to the court in a reference list that is in paper form and under seal. The reference list must specify an appropriate identifier that corresponds uniquely to each item listed. Any reference in the document to a listed identifier will be construed to refer to the corresponding item of information. If the filer provides a reference list pursuant to this rule, the front page of the document containing the redacted information must indicate that the reference list has been, or will be, provided. On its own initiative, the court may order a sealed reference list in any case.

**(g)** ***Sealed materials.***--Materials that are required by statute to be sealed, redacted, or kept confidential, such as the items set out in Articles 35.29 (Personal Information About Jurors), 38.45 (Evidence Depicting or Describing Abuse of or Sexual Conduct by Child or Minor), and 42.12, § 9(j), must be treated in accordance with the pertinent statutes and shall not be publicly available on the internet. A court may also order that a document be filed under seal in paper form or electronic form, without redaction. The court may later unseal the document or order the filer to provide a redacted version of the document for the public record. If a court orders material sealed, whether it be sensitive data or other materials, the court's sealing order must be affixed to the outside of the sealed container if the sealed material is filed in paper form, or be the first document that appears if filed in electronic form. Sealed portions of the clerk's and reporter's records should be clearly marked and separated from unsealed portions and tendered as separate records, whether in paper form or electronic form. Sealed material shall not be available either on the internet or in other form without court order.

**(h)** ***Waiver of Protection of Identifiers.***--A person waives the protection of this rule as to a person's own information by filing it without redaction and not under seal.

## History

Amended by Texas Supreme Court, Misc. Docket No. 08-9115 and Texas Court of Criminal Appeals, Misc. Docket No. 08-103, effective September 1, 2008; Amended by Texas Supreme Court, Misc. Docket No. 11-9118 and Texas Court of Criminal Appeals, Misc. Docket No. 11-001, effective June 30, 2011; Amended by Texas Supreme Court, Misc. Docket No. 12-9190 and Texas Court of Criminal Appeals, Misc. Docket No. 12-001, effective December 1, 2012; Amended by Texas Supreme Court, Misc. Docket No. 13-9032, effective March 4, 2013; Amended by Texas Supreme Court, Misc. Docket No. 13-9165, Texas Court of Criminal Appeals, Misc. Docket No. 13-003, effective January 1, 2014, and Texas Court of Criminal Appeals, Misc. Docket No. 15-005, effective November 1, 2015.

**EDITOR'S NOTE. --**
In Misc. Docket No. 13-004, the Court of Criminal Appeals ordered that "Pursuant to Rule 9.3, unless otherwise directed, the Court of Criminal Appeals requires ten paper copies of Petitions for Discretionary Review, Briefs, Replies, Motions for Rehearing that are filed electronically pursuant Rule 9.2(c), and applications filed in the trial court pursuant to Code of Criminal Procedure Article 11.071. The Court will determine on a case-by-case basis whether copies should be provided on original matters filed pursuant to Rule 72. When a document is filed electronically, the Court will notify the party of the case number. A party must include this Court's case number on all copies."
2008 amendment, by G.O. 08-9115 & 08-103, rewrote 9.3(b), which read: "A party must file the original and 11 copies of any document addressed to either the Supreme Court or the Court of Criminal Appeals, except that only the original of the following must be filed in the Court of Criminal Appeals:
(1) a motion for extension of time or a response to the motion; or
(2) a pleading under Code of Criminal Procedure article 11.07.";
and added 9.8.
2011 amendment, by G.O. 11-9118 & 08-103, rewrote 9.2(c), which read: "Electronic Filing. A court of appeals may by local rule permit documents to be filed, signed, or verified by electronic means that are consistent with technological standards, if any, that the Supreme Court establishes."; added the catchline in 9.3(a)(1); rewrote 9.3(a)(2), which read: "A court of appeals may by local rule require the filing of more or fewer copies of any

document other than a petition for discretionary review."; and rewrote 9.3(b), which read: "Supreme Court and Court of Criminal Appeals. A party must file the original and 11 copies of any document addressed to either the Supreme Court or the Court of Criminal Appeals, except that in the Supreme Court, only an original and two copies must be filed of a motion for extension of time or a response to the motion, and in the Court of Criminal Appeals, only the original must be filed of a motion for extension of time or a response to the motion, or a pleading under Code of Criminal Procedure article 11.07."

2012 amendment, by G.O. 12-9190 and 12-001, rewrote 9.4(e), which read: "A document must be printed in standard 10-character-per-inch (cpi) nonproportionally spaced Courier typeface or in 13-point or larger proportionally spaced typeface. But if the document is printed in a proportionally spaced typeface, footnotes may be printed in typeface no smaller than 10-point;" inserted 9.4(i); relettered former 9.4(i) as 9.4(j); and in 9.4(j), deleted the last sentence, which read: "The use of footnotes, smaller or condensed typeface, or compacted or compressed printing features to avoid the limits of these rules are grounds for the court to strike a document."

2013 amendment, by G.O. 13-9032, added "that is subject to a word limit under this rule" to 9.4(i)(3).

2013 amendment, by Texas Supreme Court, Misc. Docket No. 13-9165 and Texas Court of Criminal Appeals Misc. Docket No. 13-003, substituted "Documents" for "Papers" in the catchline; added "and email address" to 9.1(a) and to the last sentence to 9.1(b); added 9.1(c); substituted "or a commercial delivery service" for "first-class, express, registered, or certified mail" in 9.3(b)(1)(A); added or delivered to a commercial delivery Service" in 9.2(b)(1)(C); added 9.2(b)(2)(D); rewrote 9.2(c) which read "Documents may be permitted or required to be filed, signed, or verified by electronic means by order of the Supreme Court or the Court of Criminal Appeals, or by local rule of a court of appeals. A technical failure that precludes a party's compliance with electronic-filing procedures cannot be a basis for disposing of any case"; deleted "; Electronic Copies" from the end of the catchline for 9.3; rewrote 9.3(a), which previously read:

"(a) Courts of Appeals.

(1) Paper Copies in General. A party must file:

(A) the original and three copies of all documents in an original proceeding;

(B) the original and two copies of all motions in an appellate proceeding; and

(C) the original and five copies of all other documents.

(2) Local Rules. A court of appeals may by local rule require:

(A) the filing of more or fewer paper copies of any document other than a petition for discretionary review; and

(B) an electronic copy of a document filed in paper form.";

in 9.3(b)(1), deleted "Paper copies of" at the beginning of the catchline, and added "If a document is not electronically filed," in the first sentence; deleted 9.3(b)(2), which read: "Electronic Copies of Documents Filed in Paper Form. An electronic copy of a document filed in paper form may be required by order of the Supreme Court or the Court of Criminal Appeals."; renumbered former 9.3(b)(3) as 9.3(b)(2); in 9.3(b)(2), deleted "Paper copies of" at the beginning of the catchline, added "Paper" at the beginning of the first sentence and substituted "three business days" for "one business day"; added "including a paper copy of an electronically filed document," to the introductory paragraph of 9.4; rewrote the last sentence in 9.4(a), which read: "Printing may be on both sides of the paper."; substituted "Documents" for "Papers" in 9.4(c); added "paper" three times in 9.4(f); added "email address" in 9.4(g); rewrote 9.4(h), which read: "Appendix. An appendix may be bound either with the document to which it is related or separately. If separately bound, the appendix must comply with paragraph (f). An appendix should be tabbed and indexed."; deleted "and response" following "discretionary review" in 9.4(i)(D); deleted "to a response" in 9.4(i)(E); added 9.4(j); rewrote former 9.4(j) as 9.4(k) and rewrote the text, which read: "Unless every copy of a document conforms to these rules, the court may strike the document and return all nonconforming copies to the filing party. The court must identify the error to be corrected and state a deadline for the party to resubmit the document in a conforming format. If another nonconforming document is filed, the court may strike the document and prohibit the party from filing further documents of the same kind."; in 9.5(a), added the second sentence and added the exception in the third sentence; rewrote the text of 9.5(b), which read: "Service on a party represented by counsel must be made on that party's lead counsel. Service may be personal, by mail, by commercial delivery service, or by fax. Personal service includes delivery to any responsible person at the office of the lead counsel for the party served."; added 9.5(c)(4); added 9.9 and 9.10; and made related and stylistic changes.

PUBLICATION REFERENCES. --See *Texas Litigation Guide*, Ch. 147, *Perfecting and Docketing the Appeal*; Ch. 149, *The Appellate Record*; Ch. 150, *Appellate Proceedings in Court of Appeals*; Ch. 151, *Appellate Proceedings in*

*Supreme Court*; Ch. 152, *Original Proceedings in Court of Appeals and Supreme Court*; Ch. 153, *Accelerated Appeals*; Ch. 154, *Restricted Appeals*.

Comment to 1997 change This is former Rule 4. Subdivision 9.4, prescribing the form of documents filed in the appellate courts, is changed and the form to be used is stated in significantly more detail. Former subdivisions (f) and (g), regarding service of documents, are merged into subdivision 9.5. Former Rule 6 is included as subdivision 9.6, but no substantive change is made. Other changes are made throughout the rule. Electronic filing is authorized by §§ 51.801--.807 of the Government Code.

Comment to 2002 change The change [to Rule 9.5(a)] clarifies that the filing party must serve a copy of the document filed on all other parties, not only in an appeal or review, but in original proceedings as well. The rule applies only to filing *parties*. Thus, when the clerk or court reporter is responsible for filing the record, as in cases on appeal, a copy need not be served on the parties. The rule for original civil proceedings, in which a party is responsible for filing the record, is stated in subdivision 52.7.

Comment to 2002 change Subdivision 9.7 is added to provide express authorization for the practice of adopting by reference all or part of another party's filing.

Comment to 2008 change by G.O. 08-9115 & 08-103 Subdivision 9.3 is amended to reduce the number of copies of a motion for extension of time or response filed in the Supreme Court. Subdivision 9.8 is new. To protect the privacy of minors in suits affecting the parent-child relationship (SAPCR), including suits to terminate parental rights, Section 109.002(d) of the Family Code authorizes appellate courts, in their opinions, to identify parties only by fictitious names or by initials. Similarly, Section 56.01(j) of the Family Code prohibits identification of a minor or a minor's family in an appellate opinion related to juvenile court proceedings. But as appellate briefing becomes more widely available through electronic media sources, appellate courts' efforts to protect minors' privacy by disguising their identities in appellate opinions may be defeated if the same children are fully identified in briefs and other court papers available to the public. The rule provides protection from such disclosures. Any fictitious name should not be pejorative or suggest the person's true identity. The rule does not limit an appellate court's authority to disguise parties' identities in appropriate circumstances in other cases. Although appellate courts are authorized to enforce the rule's provisions requiring redaction, parties and amici curiae are responsible for ensuring that briefs and other papers submitted to the court fully comply with the rule. [Comment amended effective September 1, 2008, Texas Supreme Court, Misc. Docket No. 08-9115a, August 25, 2008.]

Comment to 2012 Change by G.O. 12-9190 &12-001 Rule 9 is revised to consolidate all length limits and establish word limits for documents produced on a computer. All documents produced on a computer must comply with the word limits. Page limits are retained for documents that are typewritten or otherwise not produced on a computer.

Comment to 2013 Change by G.O. 13-9165 and 13-003 Rule 9 is revised to incorporate rules for electronic filing, in accordance with the Supreme Court's order -- Misc. Docket No. 12-9206, amended by Misc. Docket Nos. 13-9092 and 13-9164 -- mandating electronic filing in civil cases in appellate courts, effective January 1, 2014. In addition, Rule 9.9 is added to provide privacy protection for all documents, both paper and electronic, filed in civil cases in appellate courts.

# Tex. R. App. P. Rule 11

This document is current through July 20, 2016

***Texas Court Rules > STATE RULES > TEXAS RULES OF APPELLATE PROCEDURE > SECTION ONE. GENERAL PROVISIONS***

## Rule 11 Amicus Curiae Briefs

An appellate clerk may receive, but not file, an amicus curiae brief. But the court for good cause may refuse to consider the brief and order that it be returned. An amicus curiae brief must:

**(a)** comply with the briefing rules for parties;

**(b)** identify the person or entity on whose behalf the brief is tendered;

**(c)** disclose the source of any fee paid or to be paid for preparing the brief; and

**(d)** certify that copies have been served on all parties.



**End of Document**

# Tex. Tax Code § 171.1011

This document is current through the 2015 regular session, 84th Legislature.

***Texas Statutes & Codes Annotated by LexisNexis® > Tax Code > Title 2 State Taxation > Subtitle F Franchise Tax > Chapter 171 Franchise Tax > Subchapter C Determination of Taxable Margin; Allocation and Apportionment***

## Sec. 171.1011. Determination of Total Revenue from Entire Business.

**(a)** In this section, a reference to an Internal Revenue Service form includes a variant of the form. For example, a reference to Form 1120 includes Forms 1120-A, 1120-S, and other variants of Form 1120. A reference to an Internal Revenue Service form also includes any subsequent form with a different number or designation that substantially provides the same information as the original form.

**(b)** In this section, a reference to an amount reportable as income on a line number on an Internal Revenue Service form is the amount entered to the extent the amount entered complies with federal income tax law and includes the corresponding amount entered on a variant of the form, or a subsequent form, with a different line number to the extent the amount entered complies with federal income tax law.

**(c)** Except as provided by this section, and subject to Section 171.1014, for the purpose of computing its taxable margin under Section 171.101, the total revenue of a taxable entity is:

**(1)** for a taxable entity treated for federal income tax purposes as a corporation, an amount computed by:

**(A)** adding:

**(i)** the amount reportable as income on line 1c, Internal Revenue Service Form 1120;

**(ii)** the amounts reportable as income on lines 4 through 10, Internal Revenue Service Form 1120; and

**(iii)** any total revenue reported by a lower tier entity as includable in the taxable entity's total revenue under Section 171.1015(b); and

**(B)** subtracting:

**(i)** bad debt expensed for federal income tax purposes that corresponds to items of gross receipts included in Subsection (c)(1)(A) for the current reporting period or a past reporting period;

**(ii)** to the extent included in Subsection (c)(1)(A), foreign royalties and foreign dividends, including amounts determined under Section 78 or Sections 951—964, Internal Revenue Code;

**(iii)** to the extent included in Subsection (c)(1)(A), net distributive income from a taxable entity treated as a partnership or as an S corporation for federal income tax purposes;

**(iv)** allowable deductions from Internal Revenue Service Form 1120, Schedule C, to the extent the relating dividend income is included in total revenue;

**(v)** to the extent included in Subsection (c)(1)(A), items of income attributable to an entity that is a disregarded entity for federal income tax purposes; and

**(vi)** to the extent included in Subsection (c)(1)(A), other amounts authorized by this section;

**(2)** for a taxable entity treated for federal income tax purposes as a partnership, an amount computed by:

**(A)** adding:

**(i)** the amount reportable as income on line 1c, Internal Revenue Service Form 1065;

**(ii)** the amounts reportable as income on lines 4, 6, and 7, Internal Revenue Service Form 1065;

**(iii)** the amounts reportable as income on lines 3a and 5 through 11, Internal Revenue Service Form 1065, Schedule K;

**(iv)** the amounts reportable as income on line 17, Internal Revenue Service Form 8825;

**(v)** the amounts reportable as income on line 11, plus line 2 or line 45, Internal Revenue Service Form 1040, Schedule F; and

**(vi)** any total revenue reported by a lower tier entity as includable in the taxable entity's total revenue under Section 171.1015(b); and

**(B)** subtracting:

**(i)** bad debt expensed for federal income tax purposes that corresponds to items of gross receipts included in Subsection (c)(2)(A) for the current reporting period or a past reporting period;

**(ii)** to the extent included in Subsection (c)(2)(A), foreign royalties and foreign dividends, including amounts determined under Section 78 or Sections 951—964, Internal Revenue Code;

**(iii)** to the extent included in Subsection (c)(2)(A), net distributive income from a taxable entity treated as a partnership or as an S corporation for federal income tax purposes;

**(iv)** to the extent included in Subsection (c)(2)(A), items of income attributable to an entity that is a disregarded entity for federal income tax purposes; and

**(v)** to the extent included in Subsection (c)(2)(A), other amounts authorized by this section; or

**(3)** for a taxable entity other than a taxable entity treated for federal income tax purposes as a corporation or partnership, an amount determined in a manner substantially equivalent to the amount for Subdivision (1) or (2) determined by rules that the comptroller shall adopt.

**(d)** Subject to Section 171.1014, a taxable entity that is part of a federal consolidated group shall compute its total revenue under Subsection (c) as if it had filed a separate return for federal income tax purposes.

**(e)** A taxable entity that owns an interest in a passive entity shall exclude from the taxable entity's total revenue the taxable entity's share of the net income of the passive entity, but only to the extent the net income of the passive entity was generated by the margin of any other taxable entity.

**(f)** A taxable entity shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), flow-through funds that are mandated by law or fiduciary duty to be distributed to other entities, including taxes collected from a third party by the taxable entity and remitted by the taxable entity to a taxing authority.

**(g)** A taxable entity shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), only the following flow-through funds that are mandated by contract or subcontract to be distributed to other entities:

**(1)** sales commissions to nonemployees, including split-fee real estate commissions;

**(2)** the tax basis as determined under the Internal Revenue Code of securities underwritten; and

**(3)** subcontracting payments made under a contract or subcontract entered into by the taxable entity to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, remediation, or repair of improvements on real property or the location of the boundaries of real property.

**(g-1)** A taxable entity that is a lending institution shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), proceeds from the principal repayment of loans.

**(g-2)** A taxable entity shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), the tax basis as determined under the Internal Revenue Code of securities and loans sold.

**(g-3)** A taxable entity that provides legal services shall exclude from its total revenue:

**(1)** to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), the following flow-through funds that are mandated by law, contract, or fiduciary duty to be distributed to the claimant by the claimant's attorney or to other entities on behalf of a claimant by the claimant's attorney:

**(A)** damages due the claimant;

**(B)** funds subject to a lien or other contractual obligation arising out of the representation, other than fees owed to the attorney;

**(C)** funds subject to a subrogation interest or other third-party contractual claim; and

**(D)** fees paid an attorney in the matter who is not a member, partner, shareholder, or employee of the taxable entity;

**(2)** to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), reimbursement of the taxable entity's expenses incurred in prosecuting a claimant's matter that are specific to the matter and that are not general operating expenses; and

**(3)** $500 per pro bono services case handled by the attorney, but only if the attorney maintains records of the pro bono services for auditing purposes in accordance with the manner in which those services are reported to the State Bar of Texas.

**(g-4)** A taxable entity that is a pharmacy cooperative shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), flow-through funds from rebates from pharmacy wholesalers that are distributed to the pharmacy cooperative's shareholders. A taxable entity that provides a pharmacy network shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), reimbursements, pursuant to contractual agreements, for payments to pharmacies in the pharmacy network.

**(g-5)** A taxable entity that is a qualified live event promotion company shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), a payment made to an artist in connection with the provision of a live entertainment event or live event promotion services.

**(g-6)** A taxable entity that is a qualified destination management company as defined by Section 151.0565 shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), payments made to other persons to provide services, labor, or materials in connection with the provision of destination management services as defined by Section 151.0565.

**(g-7)** A taxable entity that is a qualified courier and logistics company shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), subcontracting payments made by the taxable entity to nonemployee agents for the performance of delivery services on behalf of the taxable entity. For purposes of this subsection, "qualified courier and logistics company" means a taxable entity that:

**(1)** receives at least 80 percent of the taxable entity's annual total revenue from its entire business from a combination of at least two of the following courier and logistics services:

**(A)** expedited same-day delivery of an envelope, package, parcel, roll of architectural drawings, box, or pallet;

**(B)** temporary storage and delivery of the property of another entity, including an envelope, package, parcel, roll of architectural drawings, box, or pallet; and

**(C)** brokerage of same-day or expedited courier and logistics services to be completed by a person or entity under a contract that includes a contractual obligation by the taxable entity to make payments to the person or entity for those services;

**(2)** during the period on which margin is based, is registered as a motor carrier under Chapter 643, Transportation Code, and if the taxable entity operates on an interstate basis, is registered as a motor carrier or broker under the unified carrier registration system, as defined by Section 643.001, Transportation Code, during that period;

- **(3)** maintains an automobile liability insurance policy covering individuals operating vehicles owned, hired, or otherwise used in the taxable entity's business, with a combined single limit for each occurrence of at least $1 million;
- **(4)** maintains at least $25,000 of cargo insurance;
- **(5)** maintains a permanent nonresidential office from which the courier and logistics services are provided or arranged;
- **(6)** has at least five full-time employees during the period on which margin is based;
- **(7)** is not doing business as a livery service, floral delivery service, motor coach service, taxicab service, building supply delivery service, water supply service, fuel or energy supply service, restaurant supply service, commercial moving and storage company, or overnight delivery service; and
- **(8)** is not delivering items that the taxable entity or an affiliated entity sold.

**(g-8)** A taxable entity that is primarily engaged in the business of transporting aggregates shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), subcontracting payments made by the taxable entity to independent contractors for the performance of delivery services on behalf of the taxable entity. In this subsection, "aggregates" means any commonly recognized construction material removed or extracted from the earth, including dimension stone, crushed and broken limestone, crushed and broken granite, other crushed and broken stone, construction sand and gravel, industrial sand, dirt, soil, cementitious material, and caliche.

**(g-9)** [Blank]

**(g-10)** A taxable entity that is primarily engaged in the business of transporting barite shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), subcontracting payments made by the taxable entity to nonemployee agents for the performance of transportation services on behalf of the taxable entity. For purposes of this subsection, "barite" means barium sulfate ($BaSO_4$), a mineral used as a weighing agent in oil and gas exploration.

**(g-11)** A taxable entity that is primarily engaged in the business of performing landman services shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), subcontracting payments made by the taxable entity to nonemployees for the performance of landman services on behalf of the taxable entity. In this subsection, 'landman services' means:

- **(1)** performing title searches for the purpose of determining ownership of or curing title defects related to oil, gas, or other related mineral or petroleum interests;
- **(2)** negotiating the acquisition or divestiture of mineral rights for the purpose of the exploration, development, or production of oil, gas, or other related mineral or petroleum interests; or
- **(3)** negotiating or managing the negotiation of contracts or other agreements related to the ownership of mineral interests for the exploration, exploitation, disposition, development, or production of oil, gas, or other related mineral or petroleum interests.

**(h)** If the taxable entity belongs to an affiliated group, the taxable entity may not exclude payments described by Subsection (f), (g), (g-1), (g-2), (g-3), or (g-4) that are made to entities that are members of the affiliated group.

**(i)** Except as provided by Subsection (g), a payment made under an ordinary contract for the provision of services in the regular course of business may not be excluded.

**(j)** Any amount excluded under this section may not be included in the determination of cost of goods sold under Section 171.1012 or the determination of compensation under Section 171.1013.

**(k)** A taxable entity that is a professional employer organization shall exclude from its total revenue payments received from a client for wages, payroll taxes on those wages, employee benefits, and workers' compensation benefits for the covered employees of the client.

**(*l*)** For purposes of Subsection (g)(1):

**(1)** "Sales commission" means:

**(A)** any form of compensation paid to a person for engaging in an act for which a license is required by Chapter 1101, Occupations Code; or

**(B)** compensation paid to a sales representative by a principal in an amount that is based on the amount or level of certain orders for or sales of the principal's product and that the principal is required to report on Internal Revenue Service Form 1099-MISC.

**(2)** "Principal" means a person who:

**(A)** manufactures, produces, imports, distributes, or acts as an independent agent for the distribution of a product for sale;

**(B)** uses a sales representative to solicit orders for the product; and

**(C)** compensates the sales representative wholly or partly by sales commission.

**(m)** A taxable entity shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), dividends and interest received from federal obligations.

**(m-1)** A taxable entity that is a management company shall exclude from its total revenue reimbursements of specified costs incurred in its conduct of the active trade or business of a managed entity, including "wages and cash compensation" as determined under Sections 171.1013(a) and (b).

**(n)** Except as provided by Subsection (o), a taxable entity that is a health care provider shall exclude from its total revenue:

**(1)** to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), the total amount of payments the health care provider received:

**(A)** under the Medicaid program, Medicare program, Indigent Health Care and Treatment Act (Chapter 61, Health and Safety Code), and Children's Health Insurance Program (CHIP);

**(B)** for professional services provided in relation to a workers' compensation claim under Title 5, Labor Code; and

**(C)** for professional services provided to a beneficiary rendered under the TRICARE military health system; and

**(2)** the actual cost to the health care provider for any uncompensated care provided, but only if the provider maintains records of the uncompensated care for auditing purposes and, if the provider later receives payment for all or part of that care, the provider adjusts the amount excluded for the tax year in which the payment is received.

**(n-1)** The comptroller shall adopt rules governing:

**(1)** the computation of the actual cost to a health care provider of any uncompensated care provided under Subsection (n)(2); and

**(2)** the audit requirements related to the computation of those costs.

**(o)** A health care provider that is a health care institution shall exclude from its total revenue 50 percent of the amounts described by Subsection (n).

**(p)** In this section:

**(1)** "Federal obligations" means:

**(A)** stocks and other direct obligations of, and obligations unconditionally guaranteed by, the United States government and United States government agencies; and

**(B)** direct obligations of a United States government-sponsored agency.

**(2)** “Health care institution” means:

**(A)** an ambulatory surgical center;

**(B)** an assisted living facility licensed under Chapter 247, Health and Safety Code;

**(C)** an emergency medical services provider;

**(D)** a home and community support services agency;

**(E)** a hospice;

**(F)** a hospital;

**(G)** a hospital system;

**(H)** an intermediate care facility for the mentally retarded or a home and community-based services waiver program for persons with mental retardation adopted in accordance with Section 1915(c) of the federal Social Security Act (42 U.S.C. Section 1396n);

**(I)** a birthing center;

**(J)** a nursing home;

**(K)** an end stage renal disease facility licensed under Section 251.011, Health and Safety Code; or

**(L)** a pharmacy.

**(3)** “Health care provider” means a taxable entity that participates in the Medicaid program, Medicare program, Children’s Health Insurance Program (CHIP), state workers’ compensation program, or TRICARE military health system as a provider of health care services.

**(4)** “Obligation” means any bond, debenture, security, mortgage-backed security, pass-through certificate, or other evidence of indebtedness of the issuing entity. The term does not include a deposit, a repurchase agreement, a loan, a lease, a participation in a loan or pool of loans, a loan collateralized by an obligation of a United States government agency, or a loan guaranteed by a United States government agency.

**(4-a)** “Pro bono services” means the direct provision of legal services to the poor, without an expectation of compensation.

**(4-b)** [Repealed by Acts 2007, 80th Leg., ch. 1282 (H.B. 3982), § 37(2), effective January 1, 2008.]

**(5)** “United States government” means any department or ministry of the federal government, including a federal reserve bank. The term does not include a state or local government, a commercial enterprise owned wholly or partly by the United States government, or a local governmental entity or commercial enterprise whose obligations are guaranteed by the United States government.

**(6)** “United States government agency” means an instrumentality of the United States government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the United States government. The term includes the Government National Mortgage Association, the Department of Veterans Affairs, the Federal Housing Administration, the Farmers Home Administration, the Export-Import Bank, the Overseas Private Investment Corporation, the Commodity Credit Corporation, the Small Business Administration, and any successor agency.

**(7)** “United States government-sponsored agency” means an agency originally established or chartered by the United States government to serve public purposes specified by the United States Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the United States government. The term includes the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Farm Credit System, the Federal Home Loan Bank System, the Student Loan Marketing Association, and any successor agency.

**(8)** "Vaccine" means a preparation or suspension of dead, live attenuated, or live fully virulent viruses or bacteria, or of antigenic proteins derived from them, used to prevent, ameliorate, or treat an infectious disease.

**(q)** A taxable entity shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), all revenue received that is directly derived from the operation of a facility that is:

**(1)** located on property owned or leased by the federal government; and

**(2)** managed or operated primarily to house members of the armed forces of the United States.

**(r)** A taxable entity shall exclude, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), total revenue received from oil or gas produced, during the dates certified by the comptroller pursuant to Subsection (s), from:

**(1)** an oil well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 10 barrels a day over a 90-day period; and

**(2)** a gas well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 250 mcf a day over a 90-day period.

**(s)** The comptroller shall certify dates during which the monthly average closing price of West Texas Intermediate crude oil is below $40 per barrel and the average closing price of gas is below $5 per MMBtu, as recorded on the New York Mercantile Exchange (NYMEX).

**(t)** The comptroller shall adopt rules as necessary to accomplish the legislative intent prescribed by this section.

**(u)** A taxable entity shall exclude from its total revenue the actual cost paid by the taxable entity for a vaccine.

**(v)** A taxable entity primarily engaged in the business of transporting goods by waterways that does not subtract cost of goods sold in computing its taxable margin shall exclude from its total revenue direct costs of providing transportation services by intrastate or interstate waterways to the same extent that a taxable entity that sells in the ordinary course of business real or tangible personal property would be authorized by Section 171.1012 to subtract those costs as costs of goods sold in computing its taxable margin, notwithstanding Section 171.1012(e)(3).

**(w-1)** A taxable entity primarily engaged in the business of providing services as an agricultural aircraft operation, as defined by 14 C.F.R. Section 137.3, shall exclude from its total revenue the cost of labor, equipment, fuel, and materials used in providing those services.

**(x)** A taxable entity that is registered as a motor carrier under Chapter 643, Transportation Code, shall exclude from its total revenue, to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), flow-through revenue derived from taxes and fees.

## History

Enacted by Acts 2006, 79th Leg., 3rd C.S., ch. 1 (H.B. 3), § 5, effective January 1, 2008; am. Acts 2007, 80th Leg., ch. 1282 (H.B. 3928), §§ 12, 13, 37(2), effective January 1, 2008; am. Acts 2009, 81st Leg., ch. 1360 (S.B. 636), § 3(a), effective January 1, 2010; am. Acts 2011, 82nd Leg., 1st C.S., ch. 4 (S.B. 1), § 45.03, effective January 1, 2012; am. Acts 2013, 83rd Leg., ch. 117 (S.B. 1286), § 25, effective September 1, 2013; am. Acts 2013, 83rd Leg., ch. 1006 (H.B. 2451), § 1, effective January 1, 2014; am. Acts 2013, 83rd Leg., ch. 1034 (H.B. 2766), § 1, effective January 1, 2014; am. Acts 2013, 83rd Leg., ch. 1232 (H.B. 500), §§ 7, 8, effective January 1, 2014.

# Tex. Tax Code § 171.1012

This document is current through the 2015 regular session, 84th Legislature.

***Texas Statutes & Codes Annotated by LexisNexis® > Tax Code > Title 2 State Taxation > Subtitle F Franchise Tax > Chapter 171 Franchise Tax > Subchapter C Determination of Taxable Margin; Allocation and Apportionment***

## Sec. 171.1012. Determination of Cost of Goods Sold.

**(a)** In this section:

**(1)** “Goods” means real or tangible personal property sold in the ordinary course of business of a taxable entity.

**(2)** “Production” includes construction, installation, manufacture, development, mining, extraction, improvement, creation, raising, or growth.

**(3)**

**(A)** “Tangible personal property” means:

**(i)** personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner;

**(ii)** 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

**(iii)** a computer program, as defined by Section 151.0031.

**(B)** “Tangible personal property” does not include:

**(i)** intangible property; or

**(ii)** services.

**(b)** Subject to Section 171.1014, a taxable entity that elects to subtract cost of goods sold for the purpose of computing its taxable margin shall determine the amount of that cost of goods sold as provided by this section.

**(c)** The cost of goods sold includes all direct costs of acquiring or producing the goods, including:

**(1)** labor costs;

**(2)** cost of materials that are an integral part of specific property produced;

**(3)** cost of materials that are consumed in the ordinary course of performing production activities;

**(4)** handling costs, including costs attributable to processing, assembling, repackaging, and inbound transportation costs;

**(5)** storage costs, including the costs of carrying, storing, or warehousing property, subject to Subsection (e);

**(6)** depreciation, depletion, and amortization, reported on the federal income tax return on which the report under this chapter is based, to the extent associated with and necessary for the production of goods, including recovery described by Section 197, Internal Revenue Code;

**(7)** the cost of renting or leasing equipment, facilities, or real property directly used for the production of the goods, including pollution control equipment and intangible drilling and dry hole costs;

**(8)** the cost of repairing and maintaining equipment, facilities, or real property directly used for the production of the goods, including pollution control devices;

**(9)** costs attributable to research, experimental, engineering, and design activities directly related to the production of the goods, including all research or experimental expenditures described by Section 174, Internal Revenue Code;

**(10)** geological and geophysical costs incurred to identify and locate property that has the potential to produce minerals;

**(11)** taxes paid in relation to acquiring or producing any material, or taxes paid in relation to services that are a direct cost of production;

**(12)** the cost of producing or acquiring electricity sold; and

**(13)** a contribution to a partnership in which the taxable entity owns an interest that is used to fund activities, the costs of which would otherwise be treated as cost of goods sold of the partnership, but only to the extent that those costs are related to goods distributed to the taxable entity as goods-in-kind in the ordinary course of production activities rather than being sold.

**(d)** In addition to the amounts includable under Subsection (c), the cost of goods sold includes the following costs in relation to the taxable entity's goods:

**(1)** deterioration of the goods;

**(2)** obsolescence of the goods;

**(3)** spoilage and abandonment, including the costs of rework labor, reclamation, and scrap;

**(4)** if the property is held for future production, preproduction direct costs allocable to the property, including costs of purchasing the goods and of storage and handling the goods, as provided by Subsections (c)(4) and (c)(5);

**(5)** postproduction direct costs allocable to the property, including storage and handling costs, as provided by Subsections (c)(4) and (c)(5);

**(6)** the cost of insurance on a plant or a facility, machinery, equipment, or materials directly used in the production of the goods;

**(7)** the cost of insurance on the produced goods;

**(8)** the cost of utilities, including electricity, gas, and water, directly used in the production of the goods;

**(9)** the costs of quality control, including replacement of defective components pursuant to standard warranty policies, inspection directly allocable to the production of the goods, and repairs and maintenance of goods; and

**(10)** licensing or franchise costs, including fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right directly associated with the goods produced.

**(e)** The cost of goods sold does not include the following costs in relation to the taxable entity's goods:

**(1)** the cost of renting or leasing equipment, facilities, or real property that is not used for the production of the goods;

**(2)** selling costs, including employee expenses related to sales;

**(3)** distribution costs, including outbound transportation costs;

**(4)** advertising costs;

**(5)** idle facility expense;

**(6)** rehandling costs;

**(7)** bidding costs, which are the costs incurred in the solicitation of contracts ultimately awarded to the taxable entity;

**(8)** unsuccessful bidding costs, which are the costs incurred in the solicitation of contracts not awarded to the taxable entity;

**(9)** interest, including interest on debt incurred or continued during the production period to finance the production of the goods;

**(10)** income taxes, including local, state, federal, and foreign income taxes, and franchise taxes that are assessed on the taxable entity based on income;

**(11)** strike expenses, including costs associated with hiring employees to replace striking personnel, but not including the wages of the replacement personnel, costs of security, and legal fees associated with settling strikes;

**(12)** officers' compensation;

**(13)** costs of operation of a facility that is:

**(A)** located on property owned or leased by the federal government; and

**(B)** managed or operated primarily to house members of the armed forces of the United States; and

**(14)** any compensation paid to an undocumented worker used for the production of goods. As used in this subdivision:

**(A)** "undocumented worker" means a person who is not lawfully entitled to be present and employed in the United States; and

**(B)** "goods" includes the husbandry of animals, the growing and harvesting of crops, and the severance of timber from realty.

**(f)** A taxable entity may subtract as a cost of goods sold indirect or administrative overhead costs, including all mixed service costs, such as security services, legal services, data processing services, accounting services, personnel operations, and general financial planning and financial management costs, that it can demonstrate are allocable to the acquisition or production of goods, except that the amount subtracted may not exceed four percent of the taxable entity's total indirect or administrative overhead costs, including all mixed service costs. Any costs excluded under Subsection (e) may not be subtracted under this subsection.

**(g)** A taxable entity that is allowed a subtraction by this section for a cost of goods sold and that is subject to Section 263A, 460, or 471, Internal Revenue Code, may capitalize that cost in the same manner and to the same extent that the taxable entity capitalized that cost on its federal income tax return or may expense those costs, except for costs excluded under Subsection (e), or in accordance with Subsections (c), (d), and (f). If the taxable entity elects to capitalize costs, it must capitalize each cost allowed under this section that it capitalized on its federal income tax return. If the taxable entity later elects to begin expensing a cost that may be allowed under this section as a cost of goods sold, the entity may not deduct any cost in ending inventory from a previous report. If the taxable entity elects to expense a cost of goods sold that may be allowed under this section, a cost incurred before the first day of the period on which the report is based may not be subtracted as a cost of goods sold. If the taxable entity elects to expense a cost of goods sold and later elects to capitalize that cost of goods sold, a cost expensed on a previous report may not be capitalized.

**(h)** A taxable entity shall determine its cost of goods sold, except as otherwise provided by this section, in accordance with the methods used on the federal income tax return on which the report under this chapter is based. This subsection does not affect the type or category of cost of goods sold that may be subtracted under this section.

**(i)** 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. The determination of whether a taxable entity is an owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxable entity. A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in 34 T.A.C. Section 3.357) of real property is considered to be an owner of that labor or materials and may include the costs, as allowed by this section, in the computation of cost of goods sold. Solely for purposes of this section, a taxable entity shall be treated as the owner of goods being manufactured or produced by the entity under a contract with the federal government, including any subcontracts that support a contract with the federal government, notwithstanding that the Federal Acquisition Regulation may require that title or risk of loss with respect to those goods be transferred to the federal government before the manufacture or production of those goods is complete.

**(j)** A taxable entity may not make a subtraction under this section for cost of goods sold to the extent the cost of goods sold was funded by partner contributions and deducted under Subsection (c)(13).

**(k)** Notwithstanding any other provision of this section, if the taxable entity is a lending institution that offers loans to the public and elects to subtract cost of goods sold, the entity, other than an entity primarily engaged in an activity described by category 5932 of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget, may subtract as a cost of goods sold an amount equal to interest expense. For purposes of this subsection, an entity engaged in lending to unrelated parties solely for agricultural production offers loans to the public.

**(k-1)** Notwithstanding any other provision of this section, the following taxable entities may subtract as a 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:

- **(1)** a motor vehicle rental or leasing company that remits a tax on gross receipts imposed under Section 152.026;
- **(2)** a heavy construction equipment rental or leasing company; and
- **(3)** a railcar rolling stock rental or leasing company.

**(k-2)** This subsection applies only to a pipeline entity: (1) 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 (2) 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. Notwithstanding Subsection (e)(3) or (i), a pipeline entity providing services for others related to the product that the pipeline does not own and to which this subsection applies may subtract as a cost of goods sold its depreciation, operations, and maintenance costs allowed by this section related to the services provided.

**(k-3)** For purposes of Subsection (k-2), "processing" means the physical or mechanical removal, separation, or treatment of crude oil, including finished petroleum products, natural gas, condensate, and natural gas liquids after those materials are produced from the earth. The term does not include the chemical or biological transformation of those materials.

**(*l*)** Notwithstanding any other provision of this section, a payment made by one member of an affiliated group to another member of that affiliated group not included in the combined group may be subtracted as a cost of goods sold only if it is a transaction made at arm's length.

**(m)** In this section, "arm's length" means the standard of conduct under which entities that are not related parties and that have substantially equal bargaining power, each acting in its own interest, would negotiate or carry out a particular transaction.

**(n)** In this section, "related party" means a person, corporation, or other entity, including an entity that is treated as a pass-through or disregarded entity for purposes of federal taxation, whether the person, corporation, or entity is subject to the tax under this chapter or not, in which one person, corporation, or entity, or set of related persons, corporations, or entities, directly or indirectly owns or controls a controlling interest in another entity.

**(o)** If a taxable entity, including a taxable entity with respect to which cost of goods sold is determined pursuant to Section 171.1014(e)(1), whose principal business activity is film or television production or broadcasting or the distribution of tangible personal property described by Subsection (a)(3)(A)(ii), or any combination of these activities, elects to subtract cost of goods sold, the cost of goods sold for the taxable entity shall be the costs described in this section in relation to the property and include depreciation, amortization, and other expenses directly related to the acquisition, production, or use of the property, including expenses for the right to broadcast or use the property.

**(t)** If a taxable entity that is a movie theater elects to subtract cost of goods sold, the cost of goods sold for the taxable entity shall be the costs described by this section in relation 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.

## History

Enacted by Acts 2006, 79th Leg., 3rd C.S., ch. 1 (H.B. 3), § 5, effective January 1, 2008; am. Acts 2007, 80th Leg., ch. 1282 (H.B. 3928), §§ 14, 15, effective January 1, 2008; am. Acts 2013, 83rd Leg., ch. 1232 (H.B. 500), § 9, effective January 1, 2014; am. Acts 2013, 83rd Leg., ch. 1232 (H.B. 500), § 10, effective September 1, 2013.



End of Document

# Tex. Tax Code § 171.1013

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***Texas Statutes & Codes Annotated by LexisNexis® > Tax Code > Title 2 State Taxation > Subtitle F Franchise Tax > Chapter 171 Franchise Tax > Subchapter C Determination of Taxable Margin; Allocation and Apportionment***

## Sec. 171.1013. Determination of Compensation.

**(a)** Except as otherwise provided by this section, "wages and cash compensation" means the amount entered in the Medicare wages and tips box of Internal Revenue Service Form W-2 or any subsequent form with a different number or designation that substantially provides the same information. The term also includes, to the extent not included above:

**(1)** net distributive income from a taxable entity treated as a partnership for federal income tax purposes, but only if the person receiving the distribution is a natural person;

**(2)** net distributive income from limited liability companies and corporations treated as S corporations for federal income tax purposes, but only if the person receiving the distribution is a natural person;

**(3)** stock awards and stock options deducted for federal income tax purposes; and

**(4)** net distributive income from a limited liability company treated as a sole proprietorship for federal income tax purposes, but only if the person receiving the distribution is a natural person.

**(b)** Subject to Section 171.1014, a taxable entity that elects to subtract compensation for the purpose of computing its taxable margin under Section 171.101 may subtract an amount equal to:

**(1)** subject to the limitation in Subsection (c), all wages and cash compensation paid by the taxable entity to its officers, directors, owners, partners, and employees; and

**(2)** the cost of all benefits, to the extent deductible for federal income tax purposes, the taxable entity provides to its officers, directors, owners, partners, and employees, including workers' compensation benefits, health care, employer contributions made to employees' health savings accounts, and retirement.

**(b-1)** This subsection applies to a taxable entity that is a small employer, as that term is defined by Section 1501.002, Insurance Code, and that has not provided health care benefits to any of its employees in the calendar year preceding the beginning date of its reporting period. Subject to Section 171.1014, a taxable entity to which this subsection applies that elects to subtract compensation for the purpose of computing its taxable margin under Section 171.101 may subtract health care benefits as provided under Subsection (b) and may also subtract:

**(1)** for the first 12-month period on which margin is based and in which the taxable entity provides health care benefits to all of its employees, an additional amount equal to 50 percent of the cost of health care benefits provided to its employees for that period; and

**(2)** for the second 12-month period on which margin is based and in which the taxable entity provides health care benefits to all of its employees, an additional amount equal to 25 percent of the cost of health care benefits provided to its employees for that period.

**(c)** Notwithstanding the actual amount of wages and cash compensation paid by a taxable entity to its officers, directors, owners, partners, and employees, a taxable entity may not include more than $300,000, or the amount determined under Section 171.006, per 12-month period on which margin is based, for any person in the amount of wages and cash compensation it determines under this section. If a person is paid by more than one entity of a combined group, the combined group may not subtract in relation to that person a total of more than $300,000, or the amount determined under Section 171.006, per 12-month period on which margin is based.

**(c-1)** Subject to Section 171.1014, a taxable entity that elects to subtract compensation for the purpose of computing its taxable margin under Section 171.101 may not subtract any wages or cash compensation paid to an undocumented worker. As used in this section “undocumented worker” means a person who is not lawfully entitled to be present and employed in the United States.

**(d)** A taxable entity that is a professional employer organization:

**(1)** may not include as wages or cash compensation payments described by Section 171.1011(k); and

**(2)** shall determine compensation as provided by this section only for the taxable entity’s own employees that are not covered employees.

**(e)** Subject to the other provisions of this section, in determining compensation, a taxable entity that is a client that contracts with a professional employer organization for covered employees:

**(1)** shall include payments made to the professional employer organization for wages and benefits for the covered employees as if the covered employees were actual employees of the entity;

**(2)** may not include an administrative fee charged by the professional employer organization for the provision of the covered employees; and

**(3)** may not include any other amount in relation to the covered employees, including payroll taxes.

**(f)** A taxable entity that is a management company:

**(1)** may not include as wages or cash compensation any amounts reimbursed by a managed entity; and

**(2)** shall determine compensation as provided by this section for only those wage and compensation payments that are not reimbursed by a managed entity.

**(g)** A taxable entity that is a managed entity shall include reimbursements made to the management company for wages and compensation as if the reimbursed amounts had been paid to employees of the managed entity.

**(h)** Subject to Section 171.1014, a taxable entity that elects to subtract compensation for the purpose of computing its taxable margin under Section 171.101 may not include as wages or cash compensation amounts paid to an employee whose primary employment is directly associated with the operation of a facility that is:

**(1)** located on property owned or leased by the federal government; and

**(2)** managed or operated primarily to house members of the armed forces of the United States.

## History

Enacted by Acts 2006, 79th Leg., 3rd C.S., ch. 1 (H.B. 3), § 5, effective January 1, 2008; am. Acts 2007, 80th Leg., ch. 1282 (H.B. 3928), § 16, effective January 1, 2008; am. Acts 2013, 83rd Leg., ch. 117 (S.B. 1286), § 26, effective September 1, 2013.

# Tex. Tax Code § 171.1014

This document is current through the 2015 regular session, 84th Legislature.

***Texas Statutes & Codes Annotated by LexisNexis® > Tax Code > Title 2 State Taxation > Subtitle F Franchise Tax > Chapter 171 Franchise Tax > Subchapter C Determination of Taxable Margin; Allocation and Apportionment***

## Sec. 171.1014. Combined Reporting; Affiliated Group Engaged in Unitary Business.

**(a)** Taxable entities that are part of an affiliated group engaged in a unitary business shall file a combined group report in lieu of individual reports based on the combined group's business. The combined group may not include a taxable entity that conducts business outside the United States if 80 percent or more of the taxable entity's property and payroll, as determined by factoring under Chapter 141, are assigned to locations outside the United States. In applying Chapter 141, if either the property factor or the payroll factor is zero, the denominator is one. The combined group may not include a taxable entity that conducts business outside the United States and has no property or payroll if 80 percent or more of the taxable entity's gross receipts, as determined under Sections 171.103, 171.105, and 171.1055, are assigned to locations outside the United States.

**(b)** The combined group is a single taxable entity for purposes of the application of the tax imposed under this chapter, including Section 171.002(d).

**(c)** For purposes of Section 171.101, a combined group shall determine its total revenue by:

**(1)** determining the total revenue of each of its members as provided by Section 171.1011 as if the member were an individual taxable entity;

**(2)** adding the total revenues of the members determined under Subdivision (1) together; and

**(3)** subtracting, to the extent included under Section 171.1011(c)(1)(A), (c)(2)(A), or (c)(3), items of total revenue received from a member of the combined group.

**(d)** For purposes of Section 171.101, a combined group shall make an election to subtract either cost of goods sold or compensation that applies to all of its members, or $1 million. Regardless of the election, the taxable margin of the combined group may not exceed the amount provided by Section 171.101(a)(1)(A) for the combined group.

**(d-1)** A member of a combined group may claim as cost of goods sold those costs that qualify under Section 171.1012 if the goods for which the costs are incurred are owned by another member of the combined group.

**(e)** For purposes of Section 171.101, a combined group that elects to subtract costs of goods sold shall determine that amount by:

**(1)** determining the cost of goods sold for each of its members as provided by Section 171.1012 as if the member were an individual taxable entity;

**(2)** adding the amounts of cost of goods sold determined under Subdivision (1) together; and

**(3)** subtracting from the amount determined under Subdivision (2) any cost of goods sold amounts paid from one member of the combined group to another member of the combined group, but only to the extent the corresponding item of total revenue was subtracted under Subsection (c)(3).

**(f)** For purposes of Section 171.101, a combined group that elects to subtract compensation shall determine that amount by:

**(1)** determining the compensation for each of its members as provided by Section 171.1013 as if each member were an individual taxable entity, subject to the limitation prescribed by Section 171.1013(c);

**(2)** adding the amounts of compensation determined under Subdivision (1) together; and

**(3)** subtracting from the amount determined under Subdivision (2) any compensation amounts paid from one member of the combined group to another member of the combined group, but only to the extent the corresponding item of total revenue was subtracted under Subsection (c)(3).

**(g)** [Repealed by Acts 2007, 80th Leg., ch. 1282 (H.B. 3928), § 37(3), effective January 1, 2008.]

**(h)** Each taxable entity that is part of a combined group report shall, for purposes of determining margin and apportionment, include its activities for the same period used by the combined group.

**(i)** Each member of the combined group shall be jointly and severally liable for the tax of the combined group.

**(j)** Notwithstanding any other provision of this section, a taxable entity that provides retail or wholesale electric utilities may not be included as a member of a combined group that includes one or more taxable entities that do not provide retail or wholesale electric utilities if that combined group in the absence of this subsection:

**(1)** would not meet the requirements of Section 171.002(c) solely because one or more members of the combined group provide retail or wholesale electric utilities; and

**(2)** would have less than five percent of the combined group's total revenue derived from providing retail or wholesale electric utilities.

## History

Enacted by Acts 2006, 79th Leg., 3rd C.S., ch. 1 (H.B. 3), § 5, effective January 1, 2008; am. Acts 2007, 80th Leg., ch. 1282 (H.B. 3928), §§ 17, 37(3), effective January 1, 2008; am. Acts 2013, 83rd Leg., ch. 1232 (H.B. 500), § 11, effective January 1, 2014.

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**ANALYSIS**

# How States Piggyback on Federal Personal Income Tax Calculations

April 01, 2016

Fiscal Federalism Initiative

By Anne Stauffer and Mark Robyn

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Federal income taxes are calculated in a series of steps, and most states link to one or more of those.

Of the 41 states plus the District of Columbia with broad-based personal income taxes, 40 and the District link to the federal tax system by incorporating a range of federal tax expenditures—exclusions, deductions, and credits—into their tax codes. These connections, also known as conformity, mean that changes at the federal level can affect states' tax systems and revenue, and understanding them is important for policymakers at both levels of government when evaluating federal revisions or reforms. Federal policymakers should realize that changes can affect state revenue, requiring states to decide whether to revise their own tax policies, and state leaders need to weigh the trade-offs of linking to federal tax expenditures.

Federal income taxes are calculated in a series of steps, and most states link to one or more of those. This analysis provides a summary of this process based on findings from Pew's report *Tax Code Connections: How Changes to Federal Policy Affect State Revenue*, which provided an in-depth exploration of state conformity as of 2013.[1]

## Step 1: Income

When completing their federal returns, tax filers first add up their taxable sources of income such as wages, investments, and retirement disbursements to calculate their gross or total income. Certain types of income are excluded from gross income, including employer-paid health insurance premiums, tax-deferred contributions and earnings for retirement plans such as 401(k)s, and the nontaxable portion of Social Security.

# States Link to the Federal Income Tax in Various Ways

Federal income taxes are calculated in a series of steps, and most state income taxes are linked to that system. States incorporate various federal provisions—such as exclusions, deductions, and credits—into their tax calculations, a practice known as conformity. Of the 41 states (plus the District of Columbia) with income taxes, 40 and the District have at least one of the linkages shown here.

### Step 1: Income

All taxable income sources are totaled. Certain sources, called exclusions, are not counted and therefore are not taxed.

**Taxable income sources**

+ Wages
+ Investment income, such as capital gains
+ Retirement income
+ Other

= **Gross income**

**Exclusions:**

- The value of employer-provided health insurance
- Pre-tax retirement savings contributions and earnings
- A portion of Social Security and other retirement income
- Other

### Step 2: Adjustments

Adjustments allow certain expenses to be deducted from gross income.

− Student loan interest
− College tuition
− Individual retirement account contributions
− Other

= **Adjusted gross income**

37 states and the District of Columbia link to federal taxable income sources, exclusions, and adjustments, usually by using a federal income starting point.

### Step 3: Deductions and exemptions

Deductions and exemptions allow further reductions for certain expenses and for each household member.

− Itemized deductions → 31 states and the District link to federal itemized deductions.
or standard deduction
− Personal exemptions

= **Taxable income**

### Step 4: Tax rates

Tax rates are used to calculate liability based on taxable income.

x Tax rates

= **Initial tax liability before credits**

### Step 5: Tax credits

Tax credits reduce liability on a dollar-for-dollar basis.

− Earned income tax credit (EITC) → 23 states and the District offer a tax credit based on the federal EITC.
− Child tax credit
− Higher education tax credits
− Other

= **Final federal tax liability**

Notes: This table highlights the major state linkages to federal policy discussed in Pew's report *Tax Code Connections: How Changes to Federal Policy Affect State Revenue*. However, some nuances in how states conform to these tax expenditures are not included here. The table is based on 2013 tax law and omits linkages that are not discussed in the report. See the full report for more information.



## Step 2: Adjustments

Filers may then subtract from their federal gross income certain expenses, sometimes called adjustments, such as interest payments on student loans, college tuition, and contributions to individual retirement accounts. The remaining income is their adjusted gross income, or AGI.

Most states with an income tax use federal AGI as the starting point for their tax calculations and thus conform to the federal exclusions and adjustments listed above. However, six link to the final federal figure called taxable income: the income remaining after not only exclusions and adjustments but also deductions and exemptions are subtracted. (See Step 3 below.) In both cases, exceptions occur when states selectively choose to decouple from—not link to—individual federal exclusions, adjustments, or deductions by adding those amounts back into income. In all, 37 states and the District generally followed federal exclusions and adjustments in 2013.

## Step 3: Deductions and exemptions

Federal filers then further reduce their AGI by taking additional deductions. Filers choose either to take the standard deduction—a predetermined amount based on filing status—or to itemize their deductions for specific expenses. In 2013, 23 states and the District allowed filers to claim itemized deductions based on the federal versions. Two other states had tax credits based on federal itemized deductions. In addition to the standard or itemized deductions, filers may also subtract fixed personal exemption amounts for each member of their household. The final income figure generated by these calculations is federal taxable income.

Six states used federal taxable income as their starting point and so conformed to federal itemized deductions, standard deductions, and personal exemptions in addition to the exclusions and adjustments allowed in calculating federal AGI. When these states are added to the list of those that directly linked to or offered a credit for federal itemized deductions, the total number of such states was 31 plus the District in 2013.

## Step 4: Tax rates

The next step in the federal income tax calculation is to apply the tax rate schedule to taxable income to determine the initial amount of taxes owed before credits. States do not conform to this step of the federal calculations because each state has its own tax rate schedule.

## Step 5: Tax credits

Filers then subtract any available credits to determine their final federal tax liability. In contrast to deductions, which reduce taxable income, credits directly decrease taxes owed. Some credits—known as nonrefundable credits—cannot reduce a filer's tax liability below zero, but others—called refundable credits—can result in a negative liability or payment to the filer.

Federal tax credits are available for different purposes, such as offsetting child care expenses or supplementing the earnings of low-income workers. States also provide many different types of credits, some of which are linked to federal counterparts. The most significant such connection is to the federal earned income tax credit. In 2013, 23 states and the District offered a version of it, calculated as a percentage of the federal credit.

## State deductions for federal taxes paid

A few states are connected to federal policy in a way that does not involve conformity to specific provisions. Six states permit filers to deduct all or a portion of their final federal tax liability from their state taxable income. For individual filers, this has the effect of partly offsetting a federal tax increase or decrease: A federal increase would result in a larger deduction on their state returns and lower state liability (all else being equal), while a federal cut would result in higher state taxes. Because of this link, these six states can be affected by any policy change that alters total federal tax liability, including rate changes.

*Anne Stauffer directs and Mark Robyn is an officer for Pew's research on fiscal federalism.*

# Endnotes

1. For simplicity, this analysis focuses on broad areas of state conformity, and some nuances in federal and state law are not included.

## Related Expert

Anne Stauffer
*Director*
The Pew Charitable Trusts

Report

Tax Code Connections

How changes to federal policy affect state revenue

## Related Resources

Federal Tax Reform Raises Questions, Possible Revenue Changes for States

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The Distribution of Select Federal Tax Deductions and Credits Across the States

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# Relationships Between Federal and State Income Taxes

**Submitted to**

**President's Advisory Panel on Federal Tax Reform**

**April 2005**

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# Relationships Between Federal and State Income Taxes

**Harley T. Duncan**
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**April 2005**

1. **Purpose**
   1.1. The purpose of this outline is to explain the nature of the relationships that exist between state and federal income taxes at both the individual and corporation level. It looks at the structural relationships as well as the administrative connections between the state and federal systems. It also examines the rationale supporting "conformity" between the two systems and the consequences of non-conformity for taxpayers and for states.

2. **Prevalence of Personal and Corporation Income Taxes**
   2.1. Forty-one states and D.C. impose a broad-based personal income tax. In addition, New Hampshire and Tennessee impose a tax on income from interest and dividends only. Those states not imposing a personal income tax include Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

   2.2. Forty-six states and D.C. impose a tax at the corporate or business entity level that uses net income as at least part of the base. Those states that do not have such a tax include Nevada, South Dakota, Washington and Wyoming.

   2.3. In 2003, state personal income tax collections totaled about $182 billion or roughly one-third of total state tax collections of $549 billion. Corporation income tax collections amounted to just over 5 percent of the total or $28.4 billion. For comparison purposes, federal income taxes in FY 2003 were $793.7 billion at the individual level and $131.8 billion at the corporate level.[1]

   2.4. Unlike the sales and use tax, local governments do not make extensive use of the income tax. Local income taxes are generally limited to Pennsylvania, Ohio, Indiana, and Kentucky and selected larger cities in certain states like New York and Missouri. Most local income taxes are imposed primarily on wage income.

3. **Structural Relationships**
   3.1. State income taxes, for both individuals and corporations, are heavily reliant on the structure of the federal income tax, and to a large degree, conform to many features of the federal tax base such as definitions of items of income and deduction as well as the treatment of various types of transactions.

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[1] Data from U.S. Bureau of the Census and U.S. Treasury Department Monthly Treasury Statement.

3.2. **Individual Income Taxes.** Thirty-seven of the 42 states[2] with a broad-based individual income tax conform to the federal tax base in some fashion in that they base the calculation of state tax on a federal "starting point," meaning that the first entry on the state return is a computed federal number to which various "addition and subtraction modifications[3]" are made.

3.2.1. As shown in Table I, 27 states use federal adjusted gross income (AGI) as the state starting point, and 10 states begin the state calculation with federal taxable income. In the five states that do not use a federal starting point – Alabama, Arkansas, Mississippi, New Jersey and Pennsylvania – the various items of income used to develop the state base are commonly defined with reference to the Internal Revenue Code.[4]

3.2.2. Most states also base state deductions on the federal tax. Of the 34 states that allow itemized deductions, computation of state deductions generally follows federal law. The most common modification is to "add back" or eliminate the deduction for state income taxes paid.[5]

3.2.3. Conformity to the federal tax is prevalent in other areas as well. For example, all but three states (New Jersey, Massachusetts and Pennsylvania) generally follow federal treatment of Individual Retirement Arrangements.[6]

3.2.4. Unless a state uses federal taxable income as a starting point, it usually sets it own standard deduction and personal exemption amounts. [See Table II.] These are generally lower than the comparable federal provisions, given the lower personal income tax rates.

3.2.5. In short, then, the computation of state individual income taxes generally proceeds in this fashion:

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[2] The District of Columbia is treated as a state for purposes of this analysis since its personal and corporate income taxes operate identical to those of a state government.

[3] The modifications are designed to do three things: (a) subtract items in the federal base that the state cannot constitutionally tax (e.g. interest on federal obligations); (b) add items to the state base that the federal government is constitutionally prohibited from taxing (e.g., interest on state/local obligations); and (c) providing special treatment of certain types of income as the state may choose.

[4] As recently as 2001, North Dakota, Rhode Island and Vermont computed the state income tax as a percentage of the federal tax. The prospect of annual reductions in federal liability that were beyond their control and the magnitude of which was not certain caused each of the states change their tax to one based on taxable income or AGI. This allowed them to establish their own rate structure and stabilize their revenue stream.

[5] In several states such as Illinois, Indiana, Michigan, New Jersey and Pennsylvania, the personal income tax is essentially a flat tax in which itemized deductions are not allowed. The only deductions from the base are generally a personal exemption allowance and possibly a standard deduction. For further discussion, see "Individual Income Tax Provisions in the States," Information Paper No. 4, Wisconsin Legislative Fiscal Bureau, January 2001.

[6] David Baer, "State Taxation of Social Security and Pensions in 2000," Issue Brief No. 55, AARP Public Policy Institute, Washington, D.C., 2001.

**Federal Tax Base**
Plus or Minus: State modifications
Minus: State personal exemptions
Minus: State standard deduction or itemized deductions (based on federal)
**Equals: State taxable income**

Multiplied by: State Tax Rates
**Equals: Tentative State Tax Liability**

Minus: State Tax Credits
**Equals: Final State Liability**

3.2.6. Federal tax base plus/minus state modifications less state personal exemptions less state standard deduction or state itemized deductions (based on federal itemized deductions) yielding state taxable income that is then run through state income tax rate brackets.

3.3. **Corporation Income Taxes.** There is also a substantial degree of conformity between state corporation income taxes and the federal corporate income tax, albeit the degree of similarity has declined in recent years as many states have refrained from adopting certain recent federal tax law changes. [See below.]

3.3.1. Of the 46 states that levy a tax based on corporate income, all of them effectively use federal taxable income as the starting point for state tax computations.[7] This conformity to federal taxable income may be by statutory adoption of the Internal Revenue Code provisions by reference, identification of federal taxable income as the state starting point, or a presumption that beginning with federal taxable income reflects entire net income for tax purposes (New Jersey.)[8]

3.3.2. As with the personal income tax, certain modifications are made to federal taxable income in order to arrive at state taxable income. Generally, the corporate modifications are driven by constitutional considerations or areas of nonconformity with federal law.[9]

3.4. **Types of Conformity.** State conformity with the federal tax code can be broken into two categories – rolling conformity and fixed-date conformity.

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[7] About 60 percent of the states start with Line 28 of Form 1120 (taxable income before net operating losses), and the remainder start with Line 30 which includes net operating losses.

[8] Compiled from information available through Commerce Clearing House, Inc. Available upon request.

[9] Taxpayers would also modify their taxable income to deal with a category of income called "nonbusiness income," but the issue of non-business income is not relevant to this discussion.

3.4.1. Under rolling conformity, stat law is written such that the state code is tied to the federal code on an automatic or current law basis, and additional state legislative action is not necessary to incorporate new enactments at the federal level. Instead, a state enactment would be necessary to not incorporate federal changes at the state level.

3.4.2. Under fixed date conformity, state law is tied to the federal code as of a particular date. State legislation is necessary to incorporate new federal provisions when enacted. States with this type of conformity commonly consider legislation updating their code references annually.

3.4.3. As shown in Table I, twenty states have a rolling conformity date for personal income taxes (designated as having "Current" conformity in the table.) Seventeen states have fixed-date conformity, and five states do not incorporate a federal starting point that is tied to the federal code for individual income tax purposes.

3.4.4. At the corporate level, 20 states use fixed date conformity, and 26 incorporate some form of rolling or automatic conformity into the state tax law.

3.5. **Recent Federal Changes.** Since 2001, Congress has enacted several tax law changes that have reduced the degree of conformity, particularly on the corporation income tax side. The most important of the federal changes were the bonus depreciation provisions enacted in 2002 as part of the Job Creation and Worker Assistance Act and extended and expanded in the Jobs and Growth Tax Relief Reconciliation Act in 2003.[10]

3.5.1. The effect of these Acts was to reduce the tax base (corporate base in particular), since the deduction for depreciation (increased under these bills) is taken prior to the computation of taxable income. Moreover, the change occurred at a time when states were experiencing serious fiscal difficulties due to a recession and what is commonly called the "burst of the Internet bubble."[11] The choice presented to states was to conform to the federal base or to protect their revenue base by not conforming to the bonus depreciation provisions. Protection of the revenue base was determined by most states to be paramount, given the balanced budget requirements facing them.

3.5.2. Prior to the enactment of bonus depreciation, all but two states conformed to federal depreciation allowances. Only 12 states maintained their conformity after the bonus depreciation provisions. Twenty-nine states chose not to conform to either the 2002 or the 2003 Acts, and four states conformed to one, but not the

[10] Public Law 107-147 and P.L. 108-27, respectively.

[11] From the 2nd quarter of 2002 through the 2nd quarter of 20003, total state tax receipts were about 6 percent below the prior year. Research of data back to World War II did not yield another 12-month period in which tax receipts fell below the prior year.

other.[12] In short, we went from nearly total conformity to one in which two-thirds of the states deviate from federal rules.

3.5.3. There has been a similar, but not as large, movement to decouple from other recent changes affecting the federal, and consequently, state tax base. Twelve states have chosen to not to conform to the expansion of the Section 179 expensing provisions available to small businesses.[13] While states are still making their choices, it seems that at least 1/2 of the states are likely to not conform to the recently enacted Sec. 199 deduction for Qualified Production Activity Income.[14]

3.5.4. The tax law changes at the individual level, particularly the Economic Growth and Tax Relief Reconciliation Act of 2001, have not had as profound an effect since the bulk of the federal revenue impacts were associated with the marginal tax rate reductions and the child tax credit, neither of which have an impact on states from a conformity standpoint.

3.5.5. The congressional passage of the 2001, 2002 and 2003 tax bills demonstrates a strong natural tension in federal-state conformity relationships. The federal government often uses tax cuts (particularly depreciation changes) to combat economic slowdowns and promote investment. States are forced to consider not conforming to such changes because of revenue and balanced budget considerations.

## 4. Compliance Relationships

4.1. States also rely extensively on the Internal Revenue Service and its activities as a part of and a complement to their enforcement and compliance programs.[15]

4.2. With respect to the corporation income tax, states are extremely reliant on federal determinations of taxable income. While states devote substantial resources to the audit of corporation tax returns, their audit activities are focused primarily on verifying the apportionment of income across states, examining the taxpayer's treatment of certain types of transactions, and determining the membership of the unitary group if the state employs combined reporting.

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[12] Commerce Clearinghouse, Inc., "Special Report: Corporate Income Tax and 'Bonus' Depreciation," December 4, 2003.

[13] FTA compilation based on data from Commerce Clearing House, Inc.

[14] Estimate based on information provided to the author by individual state tax agencies. Available on request.

[15] Currently, all states but one have entered into an exchange of information agreement with the Internal Revenue Service under I.R.C. § 6103. Through the agreement, they can receive, at their option, a variety of reports and abstracts on a regular basis. Some of the information available includes revenue agent reports for businesses and individuals, adjustments based on information return matching programs, and extracts from both the business and individual master files and the information returns master file.

4.3. On the individual side, states also rely heavily on federal examinations and adjustments (particularly those involving the matching of information returns) as primary enforcement tools. In addition, states use federal income tax return data for a wide range of individual, independent enforcement programs.

4.4. If federal compliance efforts were to cease, equivalent compliance efforts simply are not within the reach of most individual states, particularly given that, on average, state personal and corporation income tax rates are roughly 20-25 percent of the federal tax rates.

## 5. Information Reporting

5.1. States are also reliant on the federal information reporting mechanisms for state income tax administration. To a very considerable degree, states simply mirror federal requirements [and forms, formats, etc.] for third-party information reporting. Seldom, does a state attempt to impose requirements in excess of the federal duties; some states do, however, rely only on federal information reports and do not require separate filings at the state level. Attempting to replicate these systems individually would likely result in non-uniformity and increased burdens on taxpayers, not to mention additional expense at the state level.

5.2. Moreover, states would likely encounter legal challenges to their ability to require certain entities that may not be physically present in a state to file information reports on transactions with residents of the state. Such reports are necessary for a full accounting of income and for insuring the taxpayer has the information necessary to prepare his/her return. Use of the federal reporting infrastructure eliminates the question.

## 6. Reasons for Conformity

6.1. States conform to the federal tax code primarily as a means to simplify matters for taxpayers and to promote compliance with the state income tax. Conformity is of benefit to both taxpayers and tax agencies.

6.2. Conformity makes it simpler for taxpayers to comply with state taxes because they do not have to deal with two separate sets of tax laws, rules and definitions and do not have to maintain two sets of accounts and books. Conformity reduces the complexity especially for firms and individuals operating on an interstate basis because it promotes one set of rules instead of potentially multiple sets.

6.3. Conformity also serves the interests of states in that the reduced complexity promotes voluntary compliance. Moreover, with conformity, states can rely on federal compliance efforts to also assist and complement their efforts. It also improves the ability of states and the IRS to undertake cooperative and joint efforts to improve tax administration and compliance.

**7. Consequences of Nonconformity**

7.1. Not conforming to federal law increases complexity for taxpayers and consequently reduces voluntary compliance. Certain types of nonconformity present greater complexity than others.

7.2. Nonconformity on issues that do not involve "timing" can be relatively straightforward from a compliance perspective. That is, such nonconformity generally involves either subtraction or addition of an amount that is probably easily known to the taxpayer, and there are no consequences for future years.[16] Excluding a category of income entirely from taxation at the federal level, however, could present issues for states if the information reporting system providing taxpayers with the information necessary to comply with state law are also eliminated.

7.3. Not conforming to issues involving timing (e.g., deferral of income, depreciation, etc.) is quite a different manner. Not conforming to changes in depreciation, for example, requires a taxpayer to maintain two (or more) sets of asset accounts and to track the different federal and state basis in each asset and to recognize different amounts upon disposition. Tracking differences over time imposes significant burdens on taxpayers. Taxpayer accuracy in such matters can usually be verified only on audit, an expensive proposition for both taxpayers and tax agencies alike.

7.4. The complexity associated with timing issues makes it such that there are certain types of federal provisions that make it effectively impossible for states to not conform, particularly as it relates to individual income taxation. Individual Retirement Arrangements are an example. If, for example, IRA contributions are deductible or excluded at the federal level, but taxed at the state level, a taxpayer would have a different basis in the account when withdrawn and have differing amounts taxable at the federal and state level each year. The recordkeeping requirements would be substantial, and compliance would likely be stressed.[17]

**8. Conclusion**

8.1. Conformity between state and federal tax systems serves the interests of taxpayers, state tax agencies and the overall health of the intergovernmental fiscal system. It promotes simplification for the taxpayer and increases voluntary compliance with the tax law.

8.2. The interrelationships between federal and state systems are extensive. To a considerable degree, the federal tax base effectively defines the state tax base. In addition, states are heavily reliant on federal compliance and information reporting mechanisms for the administration of their income taxes.

8.3. As a result of these interrelationships, federal tax law changes can have both transitory and permanent structural and revenue impacts on state tax systems. At the same time, a

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[16] The issue is more complex for multistate taxpayers that must track state treatment in which they operate.

[17] The Retirement Savings Accounts and Lifetime Savings Accounts proposed in the Administration's FY 2006 budget present similar issues.

number of potential federal reforms under consideration could improve state tax systems and their administration.

8.4. State reliance on the federal income tax structure and its infrastructure is so extensive that we believe it is appropriate to operate from a premise that state income tax bases must necessarily following federal income tax bases. Moreover, we believe that if the federal income tax is eliminated, it would not be possible for states to maintain and administer their own broad-based income tax over the long term. Without a federal tax to tie to, taxpayer costs and burdens of compliance are likely to prove too burdensome, not to mention the administrative issues and burdens states would face.

Table I

STATE PERSONAL INCOME TAXES: FEDERAL STARTING POINTS

(as of January 1, 2005)

| STATE | Relation to Internal Revenue Code | Tax Base |
|---|---|---|
| ALABAMA | --- | --- |
| ALASKA | no state income tax | |
| ARIZONA | 1/1/04 | federal adjusted gross income |
| ARKANSAS | --- | --- |
| CALIFORNIA | 11/11/03 | federal adjusted gross income |
| COLORADO | Current | federal taxable income |
| CONNECTICUT | Current | federal adjusted gross income |
| DELAWARE | Current | federal adjusted gross income |
| FLORIDA | no state income tax | |
| GEORGIA | 1/1/04 | federal adjusted gross income |
| HAWAII | 12/31/03 | federal taxable income |
| IDAHO | 1/1/04 | federal taxable income |
| ILLINOIS | Current | federal adjusted gross income |
| INDIANA | 1/1/03 | federal adjusted gross income |
| IOWA | 1/1/04 | federal adjusted gross income |
| KANSAS | Current | federal adjusted gross income |
| KENTUCKY | 12/31/01 | federal adjusted gross income |
| LOUISIANA | Current | federal adjusted gross income |
| MAINE | 5/28/03 | federal adjusted gross income |
| MARYLAND | Current | federal adjusted gross income |
| MASSACHUSETTS | Current | federal adjusted gross income |
| MICHIGAN | Current (a) | federal adjusted gross income |
| MINNESOTA | 6/15/03 | federal taxable income |
| MISSISSIPPI | --- | --- |
| MISSOURI | Current | federal adjusted gross income |
| MONTANA | Current | federal adjusted gross income |
| NEBRASKA | 4/15/04 | federal adjusted gross income |
| NEVADA | no state income tax | |
| NEW HAMPSHIRE | on interest & dividends only | |
| NEW JERSEY | --- | --- |
| NEW MEXICO | Current | federal adjusted gross income |
| NEW YORK | Current | federal adjusted gross income |
| NORTH CAROLINA | 5/1/04 | federal taxable income |
| NORTH DAKOTA | Current | federal taxable income |
| OHIO | Current | federal adjusted gross income |
| OKLAHOMA | Current | federal adjusted gross income |
| OREGON | Current | federal taxable income |
| PENNSYLVANIA | --- | --- |
| RHODE ISLAND | 6/3/01 | federal adjusted gross income |
| SOUTH CAROLINA | 12/31/02 | federal taxable income |
| SOUTH DAKOTA | no state income tax | |
| TENNESSEE | on interest & dividends only | |
| TEXAS | no state income tax | |
| UTAH | Current | federal taxable income |
| VERMONT | 1/1/02 | federal taxable income |
| VIRGINIA | 12/31/03 | federal adjusted gross income |
| WASHINGTON | no state income tax | |
| WEST VIRGINIA | 1/1/04 | federal adjusted gross income |
| WISCONSIN | 12/31/02 | federal adjusted gross income |
| WYOMING | no state income tax | |
| DIST. OF COLUMBIA | Current | federal adjusted gross income |

Source: Compiled by the Federation of Tax Administrators from various sources.
--- state does not employ a federal starting point. Current indicates state has adopted IRC as currently in effect. Dates indicate state has adopted IRC as ammended to that date.
(a) or 1/1/99, taxpayer's option.

Table II

## STATE INDIVIDUAL INCOME TAXES

(Tax rates for tax year 2005 -- as of January 1, 2005)

| | TAX RATE RANGE (in percents) Low | High | Number of Brackets | INCOME BRACKETS Lowest | Highest | PERSONAL EXEMPTIONS Single | Married | Dependents | FEDERAL INCOME TAX DEDUCTIBLE |
|---|---|---|---|---|---|---|---|---|---|
| ALABAMA | 2.0 | 5.0 | 3 | 500 (b) | 3,000 (b) | 1,500 | 3,000 | 300 | * |
| ALASKA | No State Income Tax | | | | | | | | |
| ARIZONA | 2.87 | 5.04 | 5 | 10,000 (b) | 150,000 (b) | 2,100 | 4,200 | 2,300 | |
| ARKANSAS (a) | 1.0 | 7.0 (e) | 6 | 3,299 | 27,500 | 20 (c) | 40 (c) | 20 (c) | |
| CALIFORNIA (a) | 1.0 | 9.3 | 6 | 6,147 (b) | 40,346 (b) | 85 (c) | 170 (c) | 265 (c) | |
| COLORADO | 4.63 | | 1 | -----Flat rate----- | | -----------None----------- | | | |
| CONNECTICUT | 3.0 | 5.0 | 2 | 10,000 (b) | 10,000 (b) | 12,750 (f) | 24,500 (f) | 0 | |
| DELAWARE | 2.2 | 5.95 | 6 | 5,000 | 60,000 | 110 (c) | 220 (c) | 110 (c) | |
| FLORIDA | No State Income Tax | | | | | | | | |
| GEORGIA | 1.0 | 6.0 | 6 | 750 (g) | 7,000 (g) | 2,700 | 5,400 | 2,700 | |
| HAWAII | 1.4 | 8.25 | 9 | 2,000 (b) | 40,000 (b) | 1,040 | 2,080 | 1,040 | |
| IDAHO (a) | 1.6 | 7.8 | 8 | 1,129 (h) | 22,577 (h) | 3,200 (d) | 6,400 (d) | 3,200 (d) | |
| ILLINOIS | 3.0 | | 1 | -----Flat rate----- | | 2,000 | 4,000 | 2,000 | |
| INDIANA | 3.4 | | 1 | -----Flat rate----- | | 1,000 | 2,000 | 1,000 | |
| IOWA (a) | 0.36 | 8.98 | 9 | 1,242 | 55,890 | 40 (c) | 80 (c) | 40 (c) | * |
| KANSAS | 3.5 | 6.45 | 3 | 15,000 (b) | 30,000 (b) | 2,250 | 4,500 | 2,250 | |
| KENTUCKY | 2.0 | 6.0 | 5 | 3,000 | 8,000 | 20 (c) | 40 (c) | 20 (c) | |
| LOUISIANA | 2.0 | 6.0 | 3 | 12,500 (b) | 25,000 (b) | 4,500 (i) | 9,000 (i) | 1,000 (i) | * |
| MAINE (a) | 2.0 | 8.5 | 4 | 4,350 (b) | 17,350 (b) | 2,850 | 5,700 | 2,850 | |
| MARYLAND | 2.0 | 4.75 | 4 | 1,000 | 3,000 | 2,400 | 4,800 | 2,400 | |
| MASSACHUSETTS | 5.3 | | 1 | -----Flat rate----- | | 4,400 | 8,800 | 1,000 | |
| MICHIGAN (a) | 3.9 | | 1 | -----Flat rate----- | | 3,100 | 6,200 | 3,100 | |
| MINNESOTA (a) | 5.35 | 7.85 | 3 | 19,890 (j) | 65,330 (j) | 3,200 (d) | 6,400 (d) | 3,200 (d) | |
| MISSISSIPPI | 3.0 | 5.0 | 3 | 5,000 | 10,000 | 6,000 | 12,000 | 1,500 | |
| MISSOURI | 1.5 | 6.0 | 10 | 1,000 | 9,000 | 2,100 | 4,200 | 1,200 | * (s) |
| MONTANA (a) | 1.0 | 6.9 | 7 | 2,300 | 13,900 | 1,900 | 3,800 | 1,900 | * |
| NEBRASKA (a) | 2.56 | 6.84 | 4 | 2,400 (k) | 26,500 (k) | 101 (c) | 202 (c) | 101 (c) | |
| NEVADA | No State Income Tax | | | | | | | | |
| NEW HAMPSHIRE | State Income Tax is Limited to Dividends and Interest Income Only. | | | | | | | | |
| NEW JERSEY | 1.4 | 6.37 | 6 | 20,000 (l) | 75,000 (l) | 1,000 | 2,000 | 1,500 | |
| NEW MEXICO | 1.7 | 6.0 | 5 | 5,500 (m) | 16,000 (m) | 3,200 (d) | 6,400 (d) | 3,200 (d) | |
| NEW YORK | 4.0 | 7.70 | 7 | 8,000 (n) | 500,000 (n) | 0 | 0 | 1,000 | |
| NORTH CAROLINA (o) | 6.0 | 8.25 | 4 | 12,750 (o) | 120,000 (o) | 3,200 (d) | 6,400 (d) | 3,200 (d) | |
| NORTH DAKOTA (a) | 2.1 | 5.54 (p) | 5 | 29,050 (p) | 319,100 (p) | 3,200 (d) | 6,400 (d) | 3,200 (d) | |
| OHIO (a) | 0.743 | 7.5 | 9 | 5,000 | 200,000 | 1,300 (q) | 2,600 (q) | 1,300 (q) | |
| OKLAHOMA | 0.5 | 6.65 (r) | 8 | 1,000 (b) | 10,000 (b) | 1,000 | 2,000 | 1,000 | * (r) |
| OREGON (a) | 5.0 | 9.0 | 3 | 2,650 (b) | 6,550 (b) | 154 (c) | 308 (c) | 154 (c) | * (s) |
| PENNSYLVANIA | 3.07 | | 1 | -----Flat rate----- | | -----------None----------- | | | |
| RHODE ISLAND | 25.0% Federal tax rates (t) | | | | --- | --- | --- | --- | |
| SOUTH CAROLINA (a) | 2.5 | 7.0 | 6 | 2,460 | 12,300 | 3,200 (d) | 6,400 (d) | 3,200 (d) | |
| SOUTH DAKOTA | No State Income Tax | | | | | | | | |
| TENNESSEE | State Income Tax is Limited to Dividends and Interest Income Only. | | | | | | | | |
| TEXAS | No State Income Tax | | | | | | | | |
| UTAH | 2.30 | 7.0 | 6 | 700 (b) | 3,750 (b) | 2,400 (d) | 4,800 (d) | 2,400 (d) | * (u) |
| VERMONT (a) | 3.6 | 9.5 | 5 | 29,900 (v) | 326,450 (v) | 3,200 (d) | 6,400 (d) | 3,200 (d) | |
| VIRGINIA | 2.0 | 5.75 | 4 | 3,000 | 17,000 | 800 | 1,600 | 800 | |
| WASHINGTON | No State Income Tax | | | | | | | | |
| WEST VIRGINIA | 3.0 | 6.5 | 5 | 10,000 | 60,000 | 2,000 | 4,000 | 2,000 | |
| WISCONSIN (a) | 4.6 | 6.75 | 4 | 8,840 (w) | 132,580 (w) | 700 | 1,400 | 400 | |
| WYOMING | No State Income Tax | | | | | | | | |
| DIST. OF COLUMBIA | 5.0 | 9.0 (x) | 3 | 10,000 | 30,000 | 1,370 | 2,740 | 1,370 | |

## STATE INDIVIDUAL INCOME TAXES (footnotes)

Source: The Federation of Tax Administrators from various sources.
(a) 15 states have statutory provision for automatic adjustment of tax brackets, personal exemption or standard deductions to the rate of inflation. Michigan, Nebraska and Ohio indexes the personal exemption amounts only.
(b) For joint returns, the taxes are twice the tax imposed on half the income.
(c) tax credits.
(d) These states allow personal exemption or standard deductions as provided in the IRC. Utah allows a personal exemption equal to three-fourths the federal exemptions.
(e) A special tax table is available for low income taxpayers reducing their tax payments.
(f) Combined personal exemptions and standard deduction. An additional tax credit is allowed ranging from 75% to 0% based on state adjusted gross income. Exemption amounts are phased out for higher income taxpayers until they are eliminated for households earning over $55,500.
(g) The tax brackets reported are for single individuals. For married households filing separately, the same rates apply to income brackets ranging from $500 to $5,000; and the income brackets range from $1,000 to $10,000 for joint filers.
(h) For joint returns, the tax is twice the tax imposed on half the income. A $10 filing tax is charge for each return and a $15 credit is allowed for each exemption.
(i) Combined personal exemption and standard deduction.
(j) The tax brackets reported are for single individual. For married couples filing jointly, the same rates apply for income under $29,070 to over $115,510.
(k) The tax brackets reported are for single individual. For married couples filing jointly, the same rates apply for income under $4,000 to over $46,750.
(l) The tax brackets reported are for single individuals. For married couples filing jointly, the same rates apply for income under $20,000 to over $150,000.
(m) The tax brackets reported are for single individuals. For married couples filing jointly, the same rates apply for income under $8,000 to over $24,000. Married households filing separately pay the tax imposed on half the income.
(n) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from $16,000 to $500,000.
(o) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from $21,250 to $200,000. Lower exemption amounts allowed for high income taxpayers. Tax rate scheduled to decrease after tax year 2005.
(p) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from $48,500 to $319,100. An additional $300 personal exemption is allowed for joint returns or unmarried head of households.
(q) Plus an additional $20 per exemption tax credit.
(r) The rate range reported is for single persons not deducting federal income tax. For married persons filing jointly, the same rates apply to income brackets that are twice the dollar amounts. Separate schedules, with rates ranging from 0.5% to 10%, apply to taxpayers deducting federal income taxes.
(s) Deduction is limited to $10,000 for joint returns and $5,000 for individuals in Missouri and to $5,000 in Oregon.
(t) Federal Tax Liability prior to the enactment of Economic Growth and Tax Relief Act of 2001.
(u) One half of the federal income taxes are deductible.
(v) The tax brackets reported are for single individuals. For married couples filing jointly, the same rates apply for income under $49,650 to over $326,450.
(w) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from $11,780 to $176,770. An additional $250 exemption is provided for each taxpayer or spouse age 65 or over.
(x) Tax rate decreases are scheduled for tax years 2006.

ITEP
INSTITUTE ON TAXATION AND ECONOMIC POLICY

Policy Brief

*Informing the debate over tax policy nationwide*

*August 2011*

# How State Corporate Income Taxes Work

A robust corporate income ensures that profitable corporations that benefit from public services pay their fair share towards the maintenance of those services, just as working people do.. More than forty states currently levy a corporate income tax. This policy brief explains why corporations should be taxed and the basic workings of the corporate tax.

## Why Tax Corporations?

Corporations are legally considered "persons," eligible for many of the same rights and protections as ordinary men and women. And just as working families and individuals benefit from the services that state and local governments provide, so too do corporations. Corporations rely on a state's education system to provide a trained workforce, use a state's transportation system to move their products from one place to another, and depend on the state's court system and police to protect their property and business transactions. While corporations—like individuals—may pay taxes on the purchases they make or on the property they own, they should also pay taxes on the profits they realize, much in the way that people earning a living in the state pay taxes on their income.

Of course, while a corporation may be treated as a single legal person, it exists in reality as a collection of individuals—the shareholders that own it; the executives and staff that work for it; and the consumers that buy its products. As a result, any tax levied on a corporation ultimately falls on one of these groups. Economic research generally indicates that for the most part, it tends to be borne by corporate shareholders. From a fairness perspective, the corporate income tax has three important attributes:

▪ The corporate income tax is one of the most **progressive taxes** a state can levy. Since stock ownership is concentrated among the very wealthiest taxpayers, the corporate income tax falls primarily on the most affluent residents of a state.

▪ The corporate income tax is, in part, **exported to other states**. Because most multi-state corporations have shareholders around the country and around the world, the bulk of a state's corporate income tax will ultimately fall on residents of other states and countries.

▪ The corporate income tax serves as an **essential backstop** to the personal income tax. Without the corporate tax, much of the income of wealthier Americans would go entirely untaxed, as individuals could easily shelter their personal income by putting it in a corporate form.

## How Corporate Income Taxes Work

In its simplest form, the corporate income tax is a tax on corporate profits. The corporate tax is based on the "ability to pay" principle: a corporation that does not realize a profit in any one year generally does not owe any corporate income tax that year. Here's an overview of how the state corporate income tax is calculated:

▪ **Determining who can be taxed.** A given company must determine whether it has nexus in a given state—that is, the company must determine whether it engages in a sufficient level of activity in the state to be subject to tax. The amount of in-state activity in which a company must engage before achieving nexus with a state for corporate income tax purposes is defined by a little-known federal law known as Public Law 86-272, which says that a state cannot apply its corporate income tax to companies whose only connection to the state is the solicitation of orders from, or the shipment of goods to, the residents of the state. Companies are well aware of nexus requirements and may structure their operations so that they avoid "crossing the nexus threshold" — and, by extension, the corporate income tax—in some of the states in which they do business.

▪ **Measuring profits**. Potentially taxable companies must calculate the net income, or profit, that it earned over the course of the year. To do this, most states "piggyback" on the federal corporate income tax, using the federal definition of taxable income as a starting point.

▪ **Splitting income into "business" and "non-business" components.** The next step is to divide a company's taxable income into a "business income" component and a "non-business income" component. Business income is typically considered to be the profits a company earns from its day-to-day business operations.

▪ **Apportionment, or determining each state's share of corporate "business" income.** A given state is not allowed to simply tax all of the profits of any company that has nexus in the state. If states could do this, the profits of companies that operate in multiple states might be taxed many times over. For more on apportionment formulas see ITEP Brief, **"Corporate Income Tax Apportionment and the Single Sales Factor"**.

▪ **Calculating tax.** Having determined the share of its total taxable income that is attributable to a given state (including the amount of business income that can be apportioned to the state and the amount of non-business income that is allocated to the state), the resulting sum is multiplied by the state's corporate tax rates to yield a tax amount.

▪ **Subtracting credits.** Many states now allow targeted tax credits (for example, credits for research or investment activities) that companies can subtract directly from their pre-credit tax liability.

▪ **Pay the Minimum**. Most states now require that even technically unprofitable corporations must pay some minimal amount of income tax. States' minimum taxes vary from very modest flat dollar amounts to more substantial sums based on a company's net worth. For more on minimum taxes see ITEP Brief, **"State Corporate Minimum Taxes"**.

## Conclusion

The corporate income tax is an important component of many state's tax structures. Though the revenue generated from the tax has declined in recent years, a robust corporate income tax can- and should – be part of each state's tax system. Policymakers should work to understand how the corporate tax is calculated to ensure that corporations are paying their fair share. Despite the worrisome recent drop in the yield of these taxes, virtually every state now has available a straightforward set of tax reform policies that could not only end the erosion of their corporate tax base, but could help these taxes regain their former health.

# IRS CCA 201430013; 2014 IRS CCA LEXIS 59

US Internal Revenue Service

March 24, 2014

**Reporter**
2014 IRS CCA LEXIS 59; IRS CCA 201430013

## Chief Counsel Advice Memoranda 201430013

## Subject Matter

Separate and Distinct Trades or Businesses
**[*1]**

**Reference:** Release Date: 7/25/2014; CC:ITA:6

**UI List:** 446.19-06

POSTF-102646-14

## Core Terms

available information, accounting method, federal income tax purposes, research and development, privileged information, books and records, disclosure, advice, entity, elect

## Text

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

to: Associate Area Counsel (CTM), Area 5

CC:LB&I:CTM:LN

from: Chief, Branch 6

(Income Tax & Accounting)
ISSUE

Are Company and LLC separate and distinct trades or businesses within the meaning of *IRC § 446(d)*?
CONCLUSION

Based upon the available information submitted, we believe that Company and LLC are separate and distinct trades or businesses within the meaning of *IRC § 446(d)*.
FACTS

LLC was previously a subsidiary of Company that converted in Year A to a limited liability company, whose sole member is Company. LLC has not made an election under Procedure and Administration Reg. *§ 301.7701-3* to be taxed as a corporation, thus, LLC is not regarded as an entity separate from Company for federal income tax purposes but is instead treated as a division of Company.

Company's activities include sales, marketing, distribution, sale support, research and development, and administrative and headquarters functions. LLC primarily manufactures products but does provide some research and development **[*2]** services to the [TEXT REDACTED] purchaser of its products, Purchaser A. Purchaser A will subsequently sell these products to Purchaser B, who will ultimately sell the products to Company.

Company and LLC have separate books and records. These books and records are prepared at Company's location. Company and LLC are in different geographical locations. Further, Company and LLC do not share employees, but, do share the highest-level executives. Company and LLC use the same accounting method, presumably, that method is an accrual accounting method.

LAW AND ANALYSIS

*IRC § 446(d)* permits accounting methods to be chosen at the trade or business level. *Treas. Reg. § 1.446-1(d)* provides factors to be used for determining that level in specific situations.

Deciding whether Company and LLC are separate and distinct trades or businesses requires a factual determination. The currently available information fails to convince us that Company and LLC are not separate and distinct trades or businesses. The fact that LLC has failed to make an election to be taxed as a corporation and is thus, disregarded as an entity separate from Company for federal income tax purposes, does not mean that LLC can never **[*3]** be a separate and distinct trade or business. Accordingly, based on the available information, our view is that Company and LLC are separate and distinct trades or businesses within the meaning of *IRC § 446(d)*.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine the ability of the Internal Revenue Service to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

**Load Date:** 2014-07-31

# Rev. Rul. 74-270; 1974-1 C.B. 109; 1974 IRB LEXIS 572

US Internal Revenue Service

January 1974

**Reporter**

1974 IRB LEXIS 572; Rev. Rul. 74-270; 1974-1 C.B. 109

## Revenue Ruling 74-270

## Subject Matter

Section 446.-General Rule for Methods of Accounting

## Applicable Sections

26 CFR 1.446-1: General rule for methods of accounting.

**[*1]**

## Core Terms

trust department, method of accounting, taxable income, books and records, change the method, national bank, hybrid, income tax purposes, accrual method, cash receipts, disbursement method, fiduciary capacity, income tax return, cash method, fiduciary

## Text

**Change of accounting method; bank with trust department using different method.** A national bank using a hybrid method of accounting for its commercial banking activities and the cash method for its trust department that is required by Federal regulations to be operated separately may be granted permission to change its method of accounting to the accrual method and continue using the cash method for its trust department.

Advice has been requested whether permission to change the method of accounting will be granted, pursuant to section 446 (e).of the Internal Revenue Code of 1954, under the circumstances described below.

The taxpayer, a national bank, keeps its books and records and files its Federal income tax returns using a hybrid method of accounting for its commercial banking activities. It keeps its books and records and files its Federal income tax returns using the cash receipts and disbursements method with respect to its trust department. The trust department, as required by Federal statute, is operated separately having its own management, offices, and employees. The business **[*2]** of the trust department is basically different from the commercial banking activities. The cash receipts and disbursements method of accounting clearly reflects taxable income of the trust department.

The taxpayer timely requested permission to change its method of accounting for its commercial banking activities, for Federal income tax purposes, from the hybrid method to the accrual method and to continue to employ the cash receipts and disbursements method for its trust department. If such permission is granted, taxpayer will continue to maintain a complete and separate set of books and records for its trust department. Further, if the requested change is approved there will be no creation or shifting of profits or losses between the trust department and the commercial banking activities so that the taxpayer's income is not clearly reflected.

Section 446 (e) of the Code provides that a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary of the Treasury or his delegate.

Section 1.446-1 (e) (2) (i) of the Income Tax Regulations **[*3]** provides, in part, that a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless the consent of the Commissioner-is secured.

Section 1.446-1 (e) (3) of the regulations provides, in part, that permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected.

Section 481 of the Code and the regulations thereunder prescribe the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a method of accounting different from that under which the taxable income was previously computed. Certain adjustments that are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted shall be taken into account in computing the taxable income for the taxable year of the change.

Section 1.446-1 (d) of the regulations provides, in general, that where a taxpayer has two or more separate and distinct trades or businesses a different method of accounting may be used for each trade or business, **[*4]** provided the method used for each trade or business clearly reflects the income of that particular trade or business. However, no trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business. Further, that if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

The right to operate a trust department is granted by the Comptroller of the Currency pursuant to law. Under such law all national banks exercising fiduciary powers are required to segregate their general assets from assets held in any fiduciary capacity and to keep separate books and records. The banking activities and fiduciary functions must be operated separately and the separate identity of the trust department must be preserved. The activities of a trust department of a national bank are governed by regulations under the law. The trust activities differ **[*5]** basically from the banking business in that banking is a mercantile business which consists of receiving deposits, making collections and loans, discounting commercial paper, and issuing notes. The trust business is a personal service business consisting of acting as trustee, executor or administrator, registering stocks and bonds, guarding estates, and acting in other fiduciary capacities. The trust department has its own management, staff of employees, and office space.

Accordingly, under the foregoing circumstances the taxpayer will be permitted to use different methods of accounting for its commercial banking activities and its trust department for Federal income tax purposes. Further, permission will be granted by the Commissioner to change its method of accounting for its commercial banking activities, for Federal income tax purposes, from the hybrid method to the accrual method provided that the taxpayer and the Commissioner of Internal Revenue agree to the terms, conditions, and adjustments under which the change will be effected.

**Load Date:** 2005-08-12

201307727L

DATE: July 16, 2013
TO: Tony Luna, Audit Division
FROM: Teresa Bostick, Tax Policy Division
SUBJECT: Cost of Goods Sold (COGS) Deduction – Revisions to Rule 3.588

I. OVERVIEW

This memo explains the recent revisions to Rule 3.588, focusing mainly on the changes to the treatment of labor costs for purposes of the COGS deduction. These changes result in the franchise tax following the Internal Revenue Code (IRC) more closely. Although federal COGS and Texas COGS are still not identical, these revisions should simplify many audits.

II. CHANGES IN THE DEFINITION OF LABOR COSTS – RULE 3.588(D)(1)

PRIOR POLICY
Initially, we only allowed a COGS deduction for DIRECT labor costs, meaning wages and benefits paid to individuals who physically produced or acquired goods. Because supervisory labor is an INDIRECT labor cost, due to the fact that supervisors do not directly "touch" the goods, supervisory labor costs were only allowed under 3.588(f) as indirect or administrative overhead costs subject to the 4% cap.

NEW POLICY
Under the revised rule, labor costs include: (A) direct labor costs, or labor costs for individuals who actually touch the goods, and (B) indirect labor costs, or labor costs, other than service costs, that can be directly attributed to production or resale activities. Labor costs for production supervisors or project managers are examples of indirect labor costs.

This approach is based on IRC Section 263A, which requires taxpayers to capitalize into inventory both direct labor and materials costs and certain indirect costs that "directly benefit, or are incurred by reason of, the performance of production or resale activities." (For federal purposes, taxpayers may deduct these capitalized expenses when the product produced or acquired is sold.)

Rule 3.588(d)(1) now states:

A taxable entity may include in its cost of goods sold calculation labor costs, other than service costs, that are properly allocable to the acquisition or production of goods and are of the type subject to capitalization or allocation under Treasury Regulation Section 1.263A-1(e) or 1.460-5 as direct labor costs, indirect labor costs, employee benefit expenses, or pension and other related costs, WITHOUT REGARD TO WHETHER THE TAXABLE ENTITY IS REQUIRED TO OR ACTUALLY CAPITALIZES SUCH COSTS FOR FEDERAL INCOME TAX PURPOSES.

The CAPITALIZED phrase above is significant because certain taxpayers eligible to use the COGS method for franchise tax are not subject to IRC Section 263A. Others, like retailers or wholesalers whose average annual gross receipts for the previous three years are $10,000,000 or less, are not required to capitalize as many costs into inventory. Rule 3.588 clarifies that "labor costs" are expenses of the TYPE that are subject to capitalization under IRC Section 263A, WITHOUT REGARD TO WHETHER A TAXABLE ENTITY ACTUALLY CAPITALIZED THOSE EXPENSES ON ITS FEDERAL RETURN. Consequently, although small resellers have a smaller set of required capitalized costs for federal income tax purposes, they may include all of the applicable direct and indirect labor costs (other than service costs) identified in IRC Section 263A in their COGS calculation for franchise tax purposes.

In addition, the recent district court decision in WINSTEAD expanded the pool of costs that qualify as benefits 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. Rule 3.588(d)(1)(A) now states:

For purposes of this section, labor costs include W-2 wages, IRS Form 1099 payments for labor, temporary labor expenses, payroll taxes, pension contributions, and employee benefits expenses, including, but not limited to, health insurance and per diem reimbursements for travel expenses, to the extent deductible for federal tax purposes.

As under prior policy, costs excluded under 3.588(e) cannot be included in COGS regardless of how the costs are treated for federal tax purposes.

III. CHANGES IN INDIRECT AND ADMINISTRATIVE OVERHEAD COSTS–RULE 3.588(F)

The revised rule includes a new defined term: service costs. Rule 3.588(b)(9) defines "service costs" for franchise tax purposes as:

"Indirect costs and administrative overhead costs that can be identified specifically with a service department or function, or that directly benefit or are incurred by reason of a service department or function. For purposes of this section, a service department includes personnel (including costs of recruiting, hiring, relocating, assigning, and 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."

INCLUDABLE SERVICE COSTS

All service costs are "indirect or administrative overhead costs" subject to allocation under 3.588(f). Service costs that are demonstrably allocable to the acquisition or production of goods are includable in the COGS deduction, SUBJECT TO THE 4% CAP. (This is a departure from the federal approach which includes the indirect and administrative costs directly allocable to production or acquisition as a capitalizable cost recoverable as goods are sold, WITHOUT LIMITATION.) Service costs that are not allocable to the acquisition or production of goods may not be included in a taxpayer's COGS deduction, but are used to calculate the 4% cap. For example, legal services provided by a taxpayer's general counsel are indirect or administrative overhead costs that must be allocated under 3.588(f). The legal department might prepare and review all contracts for the production department, give tax advice to the tax department, and review all sales contracts for the sales department. All of the legal service costs become part of the computation of the 4% cap under 3.588(f), but only the legal services costs allocable to the preparation and review of production department contracts are includable in COGS as "indirect or administrative overhead costs."

INDIRECT LABOR COSTS & SERVICE COSTS

Indirect labor costs may also be service costs. Indirect labor costs that directly relate to production or acquisition and resale activities – and are

NOT service costs – may be fully included in COGS under 3.588(d)(1). An example is the salary and benefits paid to the head of a production division at a plant. In contrast, indirect labor costs that directly relate to production or acquisition and resale activities – and are service costs – may not be fully included in COGS under 3.588(d)(1) but are instead subject to the 4% cap under 3.588(f). In other words, all service costs, even those that might also be categorized as labor costs or other types of includable expenses, fall under 3.588(f) and are subject to the 4% cap. For example, the accounting services provided at a construction job site may be included in COGS, but will be subject to the 4% cap.

Table 1-A and 1-B, attached to this memo, provide examples of service costs and illustrate how to calculate the portion of these service costs that may be included in COGS as required by 3.588(f).

## IV. ADDITIONAL CHANGES

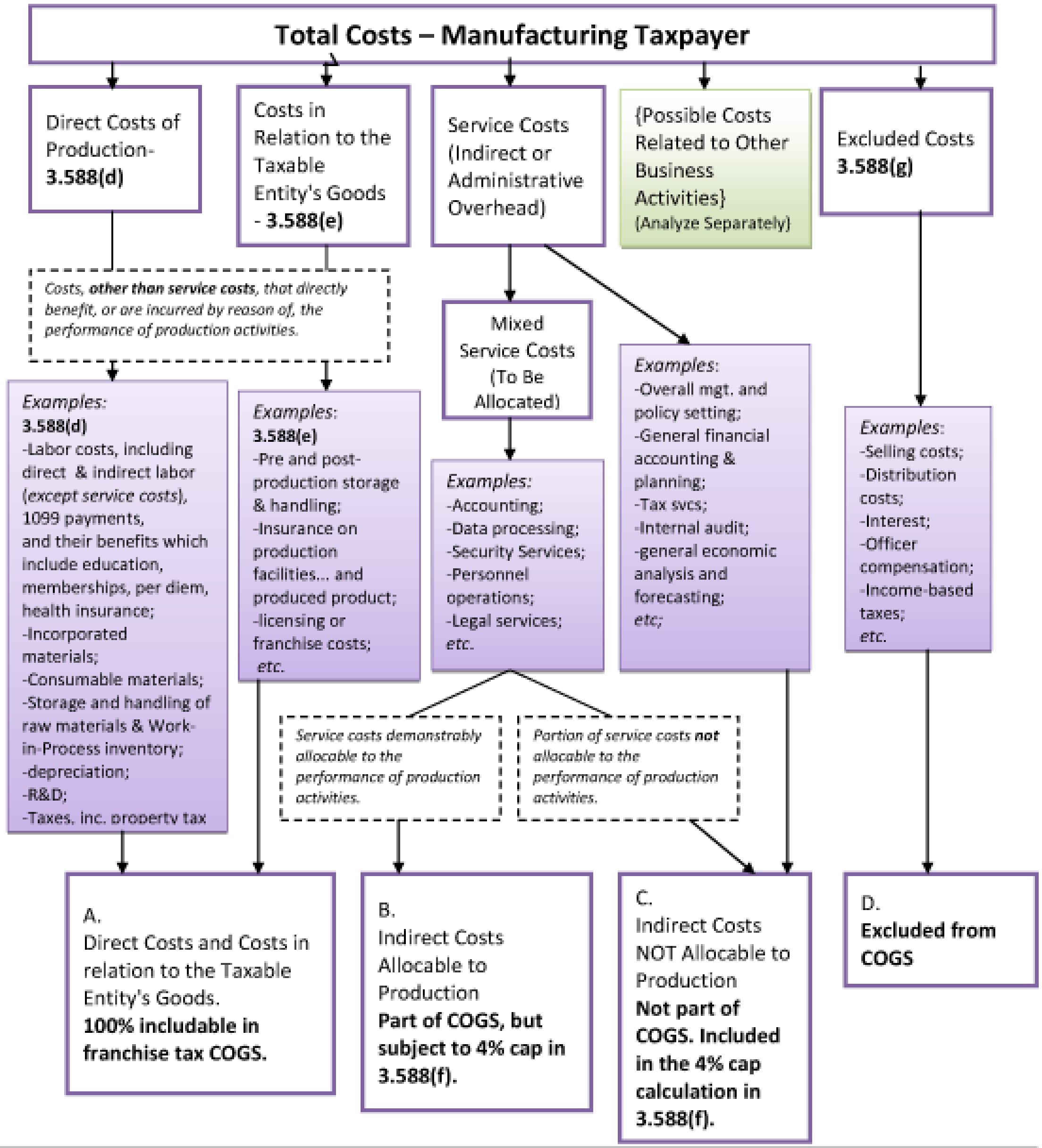
### COGS ELECTION

The previously-announced policy allowing a taxable entity to change its method of computing margin is now part of the revised rule. A taxable entity may change the method it originally elected by filing an amended report within the time allowed under Tax Code 111.107. The rule also states that an election may be changed as part of an audit.

### PROPERTY TAXES

Section 3.588(d)(11) is revised to include in direct costs property taxes paid on buildings and equipment. The section now reads: “A taxable entity may include in its cost of goods sold calculation taxes paid in relation to acquiring or producing any material, including property taxes paid on buildings and equipment, and taxes paid in relation to services that are a direct cost of production.”

**Table 1-A: Franchise Tax COGS – Guide to Categorizing Total Costs**

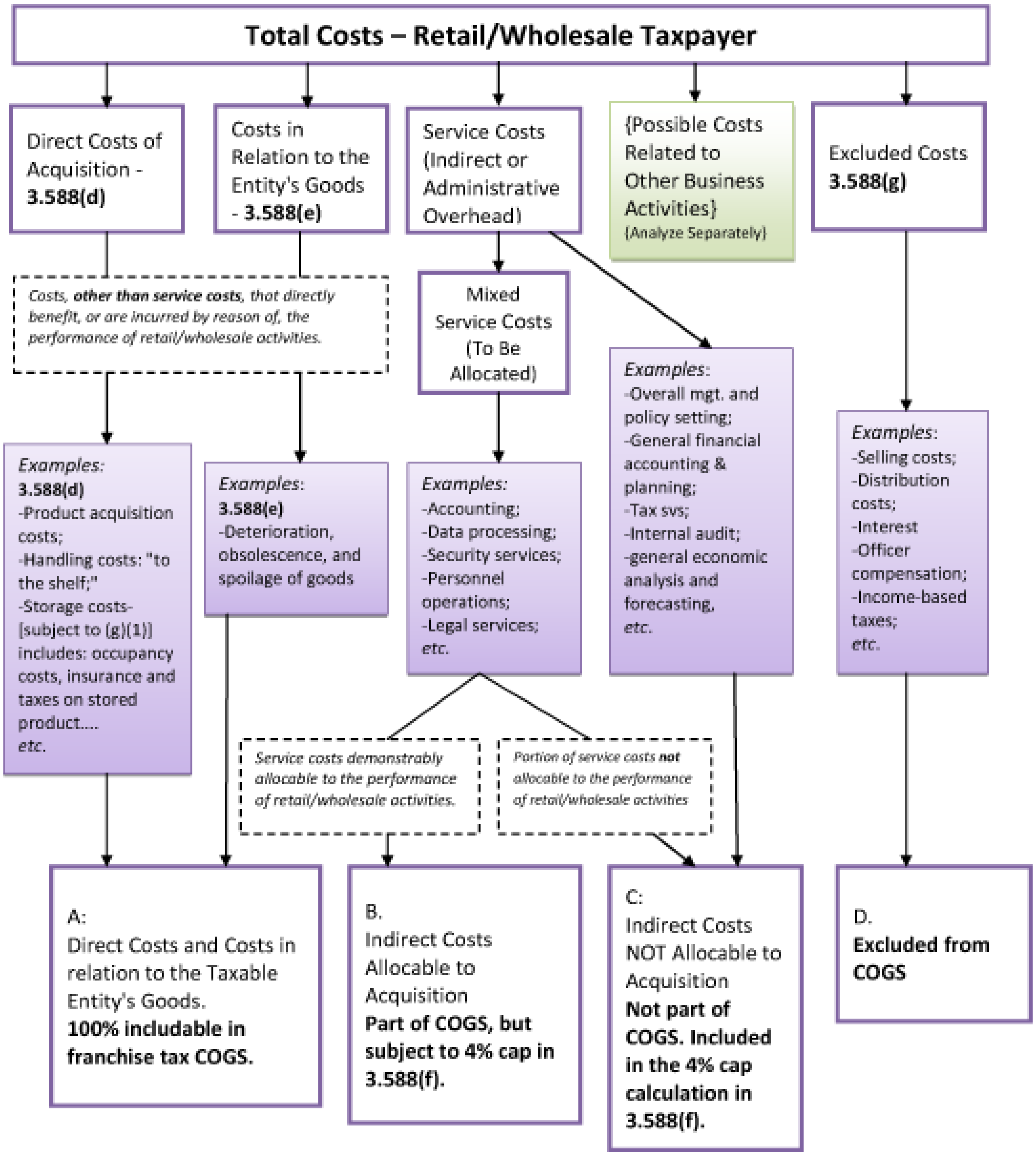



*Using the above information to calculate the amount of indirect and administrative expenses includable in COGS under 171.1012(f)*

The amount includable in COGS is the lesser of: (1) Box B or

(2) 4% of [Box B plus Box C]

**Table 1-B: Franchise Tax COGS – Guide to Categorizing Total Costs**




*Using the above information to calculate the amount of indirect and administrative expenses includable in COGS under 171.1012(f)*

The amount includable in COGS is the lesser of: (1) Box B or
(2) 4% of [Box B plus Box C]

ACCESSION NUMBER: 201307727L
SUPERSEDED: N
DOCUMENT TYPE: L
DATE: 07/16/2013
TAX TYPE: Franchise

201409972H

SOAH DOCKET NO. 304-13-5669.13
CPA HEARING NO. 108,959

RE: *************
TAXPAYER NO.: *************
AUDIT OFFICE: *************
AUDIT PERIOD: January 1, 2008 THROUGH December 31, 2008

Franchise Tax/RDT

BEFORE THE COMPTROLLER
OF PUBLIC ACCOUNTS
OF THE STATE OF TEXAS

SUSAN COMBS
Texas Comptroller of Public Accounts

PERRY HEITMAN
Representing Tax Division

*************
Representing Petitioner

SOAH DOCKET NO. 304-13-5670.13
CPA HEARING NO. 108,960

RE: *************
TAXPAYER NO.: *************
AUDIT OFFICE: *************
AUDIT PERIOD: January 1, 2009 THROUGH December 31, 2009

Franchise Tax/RDT

BEFORE THE COMPTROLLER
OF PUBLIC ACCOUNTS
OF THE STATE OF TEXAS

SUSAN COMBS
Texas Comptroller of Public Accounts

PERRY HEITMAN
Representing Tax Division

*************
Representing Petitioner

COMPTROLLER'S DECISION

The Tax Division (Staff) of the Texas Comptroller of Public Accounts (Comptroller) assessed ************* (Petitioner) after an auditor disallowed a portion of the cost of goods sold (COGS) deduction Petitioner claimed in its

2008 and 2009 franchise tax returns. Petitioner requested redetermination contending that the auditor erred when she allowed only 30% of the equipment and repair costs associated with their ready-mix cement trucks and 15% of the labor costs associated with the truck operator/driver. Petitioner also argued that the auditor erred when she disallowed 100% of the labor costs associated with their dispatcher. Staff contends the auditor's determination as to costs associated with the ready-mix trucks was correct. However, after completing a tour of Petitioner's facilities, Staff agreed to allow 59% of the truck operator/driver labor costs. Staff also agreed to allow a deduction for dispatcher labor costs but classified those costs as being related to indirect service costs that are capped at 4% of the administrative overhead total. In the Proposal for Decision (PFD), the Administrative Law Judge (ALJ) found that the COGS deduction Petitioner took in its 2008 and 2009 reports included amounts related to the processing and distribution of ready-mix cement. Because Petitioner failed to differentiate those costs, the auditor was authorized to estimate the amounts related to production based on the best information available. Petitioner failed to demonstrate that the adjusted COGS deduction for its mixer trucks and operator/drivers was incorrect, and the ALJ recommends that those contentions be denied. However, the ALJ found the auditor erred when she classified labor costs associated with Petitioner's dispatchers as indirect or administrative service costs. Indirect labor costs that directly relate to production or acquisition and resale activities (and are not service costs) may be fully included in the COGS deduction. However, a portion of the costs associated with Petitioner's dispatchers relate to events that take place after the sale of ready-mix concrete, which cannot be included in the COGS deduction. As with the other issues in this case, Petitioner's records do not differentiate allowable indirect production costs from unallowable distribution costs. Staff has made a concession on the issue, and the ALJ recommends that the Comptroller adopt that concession in her final decision. But the ALJ finds that there is no basis for allowing Petitioner to claim dispatcher costs beyond what Staff conceded. Therefore, the ALJ recommends that Petitioner's taxable margin for report years 2008 and 2009 be adjusted only as agreed by Staff.

I. PROCEDURAL HISTORY, NOTICE, AND JURISDICTION

Staff referred the above-referenced cases to the State Office of Administrative Hearings (SOAH) and, on August 12, 2013, issued Notices of Hearing. The cases were joined after ALJ Victor John Simonds determined they shared common issues of fact and law. The ALJ convened a hearing on the merits on January 14, 2014. Staff was represented by Assistant General Counsel Perry Heitman. Petitioner was represented by ************* and COMPANY A. The contested case record closed on February 25, 2014. There are no issues of notice or jurisdiction; therefore, those matters are set out in the Findings of Fact and Conclusions of Law without further discussion.

II. REASONS FOR DECISION

A. Evidence Presented

Staff presented the testimony of La Tricia Davis (the auditor) and Martha Preston (a franchise tax analyst from the Tax Policy Division). Staff offered the following exhibits for each case: the 60-day notification letter, the Texas Notification of Audit Results, the penalty and interest waiver worksheet, the audit report, and the audit plan. Staff also submitted the 2010 National Ready Mixed Concrete Association (NRMCA) Fleet Benchmark and Costs Survey, certain discovery requests, and the American Society for Testing and Materials (ASTM) International Standard Specification for Ready Mixed Concrete (January 2007).

Petitioner objected to the NRMCA cost survey arguing that the document had no relevance because the auditor had not relied on it. The ALJ overruled the objection after finding the document had at least some tendency to prove a point in contention, I.E., the costs associated with operation of a ready-mix truck power take-off (PTO) unit. Petitioner also objected to the ASTM International specifications document because it was superseded when a new version was published. The ALJ overruled Petitioner's objection after noting that the specifications set forth within Staff's exhibit were in effect during the audit periods. Staff's remaining exhibits were admitted without objection.

Petitioner submitted the testimony of the following witnesses:

1. INDIVIDUAL A, president of Texas Aggregates and Concrete Association (TACA);
2. INDIVIDUAL B, Petitioner's regional vice-president and general manager;
3. INDIVIDUAL C, Petitioner's operations manager;
4. INDIVIDUAL D, Petitioner's area manager; and
5. INDIVIDUAL E, Petitioner's tax manager.

Petitioner submitted the following exhibits:

1. Audit Report, report year 2008;
2. Audit Report, report year 2009;
3. Driver Time Metrics Chart;
4. Driver Time Metrics Chart, with auditor notes;
5. First (Draft) Revised Audit Report, report year 2008;
6. First (Draft) Revised Audit Report, report year 2009;
7. Auditor notes regarding driver time;
8. Second Revised Audit Report, report year 2008;
9. Second Revised Audit Report, report year 2009;
10. Email and letter (Apri1 30 and May 10, 2010) regarding COGS allocations;
11. Email (September 5, 2013) regarding PTO fuel use;
12. Memorandum (July 16, 2013) from Tony Luna regarding COGS deduction;
13. Petitioner audit numbers;
14. Certain responses to Staff's first discovery requests;
15. Certain responses to Staff's second discovery requests;
16. Certain responses to Staff's third discovery requests;
17. Certain supplemental responses to Staff's first discovery requests;
18. Certain Staff responses to Petitioner's first discovery requests;
19. Affidavit of La Tricia Davis;
20. Certain supplemental responses to Petitioner's first discovery requests;
21. Certain Staff responses to Petitioner's second discovery requests;
22. Photographs of Petitioner's ready-mix concrete truck;
23. Photograph of Petitioner's mixer slump tester container;
24. TACA Memorandum;
25. ASTM International Standard Specification for Ready Mixed Concrete (August 2013);
26. NRMCA Fleet Benchmarking and Costs Survey (June 2010);
27. Photographs (various);
28. Slump design chart;
29. Job Ticket, August 2007;
30. Job Ticket, November 2007;
31. Job Ticket, April 2008;
32. Job Ticket, October 2008;
33. Delivery of Concrete Tickets Document;
34. Job Description: concrete mixer operator;
35. Mixer Truck Operator Return Trip to Plant Procedure document;
36. Standard Operating Procedure document;
37. Physical Demands and Working Condition document;
38. Petitioner's "What's Your Slump?" document;
39. Petitioner's "Is Your Concrete Air Too Low?" document;
40. Driver's Vehicle and Inspection Report; and
41. Typical job flow chart.

Staff objected to Petitioner's Exhibit Nos. 24 (the TACA memorandum) and 25 (the ASTM International specification document). Petitioner explained that one of the principal authors of the TACA memorandum was expected to testify, and that the ASTM document was simply a more recent version of a similar exhibit submitted by Staff. The ALJ overruled Staff's relevancy objections noting that they relate to the weight that should be afforded the evidence, not to admissibility. The ALJ also notes that though Petitioner's Exhibit No. 25 was admitted to the record, the document specifically states that it is not an ASTM standard. Rather, Exhibit No. 25 constitutes a revision that is under consideration.

B. Agreed Adjustments

Staff agreed to adjust both audits to allow 59% of the labor costs associated with operator/drivers. Staff also agreed to allow a deduction for the dispatcher labor costs but classified them as indirect service costs, which are capped at 4% of the administrative overhead total. The proposed amended schedules are identified as Staff Hearing Exhibit Nos. 6A and 6B.

C. Facts Demonstrated by the Evidence

Petitioner is a national company that manufactures and sells concrete products. It has facilities in the CITY metroplex and also in west Texas. Each facility stores various components of ready-mix concrete (E.G., stone, sand, chemicals, water), but not every facility stores every component that might be used. Petitioner also owns a fleet of ready-mix concrete trucks that are used to manufacture and deliver concrete to Petitioner's customers. Ready-mix concrete is defined as concrete that is manufactured and delivered to a purchaser in a freshly mixed, unhardened, state. [ENDNOTE: (1)] The basis of a purchase is in cubic yards or cubic meters of freshly mixed and unhardened concrete as discharged from the transportation unit. [ENDNOTE: (2)]

Generally, Petitioner's mixer trucks are ordered in two steps. First, Petitioner must select a truck manufacturer, E.G., Mack, Freightliner, or Kenworth. For example, in 2006, Petitioner placed an order for eight Kenworth trucks that cost $************* each (after including taxes and fees). [ENDNOTE: (3)] The trucks are specifically designed to meet Petitioner's needs. Once the trucks are manufactured they are delivered to a concrete drum manufacturer, E.G., McNeilus. The drum manufacturer will outfit the truck with a mixer drum. Internally, the drum has fins and blades that assist the concrete manufacturing process. It must be placed on the truck at a specific angle and height to perform correctly. [ENDNOTE: (4)] The drum manufacturer must also add controllers (joysticks) at the back of the truck and inside the cab. The controllers allow the operator/driver to control the drum rotation speeds and track drum rotations. [ENDNOTE: (5)] In 2006, McNeilus outfitted one of Petitioner's trucks for $*************. [ENDNOTE: (6)] The drum and equipment that is used to operate the drum is generally referred to as "power takeoff" (PTO) equipment.

Filling a customer's concrete order begins with Petitioner's dispatcher. [ENDNOTE: (7)] The dispatcher will take down the various customer specifications for the concrete and determine which of Petitioner's facilities is most appropriate for completing the order. [ENDNOTE: (8)] The dispatcher will consider factors such as the location of the job site and materials availability. [ENDNOTE: (9)] These considerations are important because different plants have different materials on-hand, and because the dispatcher and the operator/driver will need to estimate the amount of time it will take to travel from the plant to the job site.

Petitioner tries to locate its facilities so that they are within a 15 to 20 mile radius of one another because the life span of its product is about 90 minutes. [ENDNOTE: (10)] Thus, travel time from the plant to the job site is a critical component in Petitioner's manufacturing operation. The distance factor is also important because Petitioner's ready-mix cement truck fleet is comprised of vehicles that are designed to make hauls that average no more than 20 to 25 miles. [ENDNOTE: (11)]

Once the dispatcher assigns the job to a facility, an operator/driver begins his tasks. Petitioner describes the various tasks that an operator/driver performs as follows:

Loading:
* Driver pushes the "in service" button on the truck computer,
* Delivery ticket is sent to the plant,
* Driver pulls under the loader/hopper and plant dispenses materials into the turning mixer drum,
* Driver rinses down the rear of the truck and checks slump of the concrete,
* Driver adds water as necessary to reach the proper slump at the plant.

To Jobsite:
* Driver leaves the plant and drives to the job site,
* Mixer is still mixing the concrete to achieve the correct slump at the job site,
* Driver is responsible for ensuring revolutions to customer specifications,
* Driver may need to adjust the slump.

Unloading:
* Driver waits until customer is ready to pour out the concrete,
* Driver reverses the turning drum to discharge the concrete down the chute,
* Concrete is poured into a wheel barrel for slump tests,
* Customer may reject load if slump test does not meet required specifications,
* Accepted concrete is poured into forms or pumps at the customer site.

Washout:
* Driver has completed the pour and has reversed the direction of the drum,
* Proceeds to the wash down area where the rear of the truck and chutes are cleaned.

To Plant:
* Driver returns to a plant to get another load or docks out,
* If usable concrete is left in the drum, it may be layered on for another load or used to create retaining wall bricks.

Petitioner also provided the auditor with a driver-time metric that showed the average time that its drivers spent performing various tasks. For example, in 2010, the average times, in minutes, were: load time, 18; travel to job time, 22; unload time, 37; washout time, 15; and travel to plant time, 26; for a total job average of 118 minutes.

When the component materials are being loaded into the truck's drum, the operator must ensure that the drum is turning at a very fast rate, a mixing speed. Once the various components are loaded into the drum, the operator/driver will climb a rack and look in to the drum to check the consistency and workability (slump) of the mix because the slump of the mix is one of the specifications customers make when they order concrete. The operator/driver is trained and knows that concrete slump is not static; it will change over time and the rate of change will fluctuate based on temperatures and concrete components. For example, if it is a particularly hot day the operator might add extra water to the drum mixture. The operator/driver must use his experience and judgment to know how much water to add so that the mix will be at the customer ordered slump when the concrete is delivered at the job site. Concrete that is completely mixed in a truck mixer will generally be at a uniform consistency after 70 to 100 drum revolutions at mixer speeds. [ENDNOTE: (12)] Once the operator/driver is satisfied with the product in the drum, he will slow the drum to an agitator speed and proceed to the job site.

No matter how experienced the operator/driver may be, he will not be able to account for every variable. For example, he may encounter an accident or road construction that delays his arrival at the job site. If one of those things occurs he will have to radio the dispatcher to ensure that trucks that may be following can be rerouted. The initial slump determination was based on an estimated arrival time.

According to the ASTM Standards, no water from the truck water system or elsewhere can be added after the initial introduction of mixing water for the batch except when on arrival at the job site the slump of the concrete is less than that specified by the customer. [ENDNOTE: (13)] If the desired slump is less than specified, and except where otherwise specified, the desired slump can be obtained with a one-time addition of water. A one-time addition of water is not prohibited from being several distinct additions of water provided no concrete has been discharged except for slump testing. All water additions shall be completed within 15 minutes from the start of the first water addition, and such additional water shall be injected into the mixer under such pressure and direction of flow to allow for proper distribution within the mixer. The drum shall be turned an additional 30 revolutions, or more if necessary, at mixing speed to ensure that a homogenous mixture is attained. Water shall not be added to the batch at any later time. Discharge of the concrete shall be completed within 1½ hours or before the drum has made 300 revolutions, whichever comes first, after the introduction of the mixing water. These limitations are permitted to be waived by the purchaser if the concrete slump is such that it can be placed, without the addition of water, to the batch. In hot weather, or under conditions that contribute to quick stiffening of the concrete, a time less than 1½ hours is permitted to be specified. [ENDNOTE: (14)]

Once the customer approves the load, the operator/driver will reverse the spin of the drum and begin offloading the concrete, which may require him to move the truck periodically. When the order is complete the operator/driver will wash down the truck, and proceed back to the plant. If he has product remaining in the drum, he may be redirected to another job. [ENDNOTE: (15)] Or, he may return to the plant to "top load" (create another base material for another customer), or the remaining mix may be used to create preformed concrete blocks. [ENDNOTE: (16)] At the end of the day, the operator/driver will washout the drum. Only when the day is complete and the drum is clean does the operator/driver stop the drum. From the beginning of the process to the final washout, the drum has been spinning. If the drum stops spinning prior to final wash out, the concrete mix components will separate or begin setting-up in the drum.

For franchise tax report years 2008 and 2009, Petitioner filed a Texas Franchise Tax Report that calculated its taxable margin utilizing the COGS deduction. The COGS deduction included 100% of Petitioner's mixer truck costs, 100% of its operator/driver salaries, and 100% of its dispatcher salaries. The auditor met with Petitioner's representatives and reviewed various business records. She determined that a portion of the COGS deduction should be disallowed.

The auditor testified that she disallowed 70% of the mixer truck costs because she concluded that, though the mixer was being utilized to manufacture cement, the truck was being used to deliver the product. The auditor also initially disallowed 85% of the operator/driver salaries, and determined that the dispatcher costs should be disallowed entirely. Subsequently, the auditor took a tour of Petitioner's facility and changed her interpretation as to costs that were allowed in a COGS deduction. In terms of percentage, she disallowed 41% of the operator/driver costs (as opposed to the previous 85%). The auditor ultimately allowed costs associated with dispatchers. However, they were designated as indirect or administrative costs, which are capped at 4% of the total indirect and administrative overhead cost. [ENDNOTE: (17)]

D. ALJ's Analysis

Franchise tax is imposed on each corporation that does business in this state or that is chartered or organized in this state. Tex. Tax Code Ann. SECTION 171.001. The taxable margin of a taxable entity is determined by calculating 70% of total revenue from the entity's total business or by subtracting, at the election of the taxpayer, either the COGS or compensation. Tex. Tax Code Ann. SECTION 171.101(a)(1), .1011, .1012, and .1013. However, the COGS and compensation methodologies are specifically defined and limited. With respect to the COGS methodology, the Tax Code defines "goods" as real or tangible personal property sold in the regular course of business, and services are specifically excluded. Tex. Tax Code Ann. SECTION 171.1012(a)(1) and .1012(a)(3)(B)(ii). As the ALJ previously discussed, Petitioner claimed a COGS deduction that included all of its costs related to its mixer trucks, all of its operator/driver labor costs, and all of its dispatcher labor costs. The auditor disallowed some of those costs. To prevail in the instant matter, Petitioner must demonstrate, by a preponderance of evidence that the auditor erred. 34 Tex. Admin. Code SECTION 1.40(2)(B).

Mixer Truck Costs

Staff argues that, by allowing 30% of all mixer truck costs, the auditor effectively allowed 100% of the costs associated with the drum. It contends costs associated with the truck itself should be disallowed as costs of distribution. Petitioner disagrees and argues that the mixer truck is one integrated unit with a single purpose, to manufacture concrete. Petitioner contends it is entitled to 100% of the costs associated with its mixer trucks because the company's finished product, concrete, is a finished product only when it is deposited at the job site and hardens.

Ultimately, resolution of the dispute involves considering the proper construction of Chapter 171 of the Texas Tax Code. When construing a statute, the primary objective is to ascertain and give effect to the Legislature's intent. SEE FIRST AM. TITLE INS. CO. V. COMBS, 258 S.W.3d 627, 631-32 (Tex. 2008). The statute is considered as a whole with each word being read in context rather than in isolation, and unless a different definition is supplied by the Legislature, courts assume the words chosen have their plain and ordinary meaning. SEE CITY OF ROCKWELL V. HUGHES, 246 S.W.3d 621, 625-26 (Tex. 2008). Moreover, for purposes of statutory construction, Texas courts treat a deduction as tantamount to an exemption and therefore construe Texas Tax Code provisions strictly against the taxpayer and in favor of the taxing authority. SEE TEXAS UTILS. ELEC. CO. V. SHARP, 962 S.W.2d 723, 726 (Tex. App.—Austin 1998).

A COGS deduction can include all direct costs of acquiring or producing goods, including (but not limited to): labor costs, costs of materials that are an integral part of the specific property being produced, costs of materials that are consumed in the ordinary course of performing production activities, handling costs (including costs attributable to processing, assembling, repackaging, and inbound transportation costs), and depreciation. Tex. Tax Code Ann. SECTION 171.1012(c). Thus, for example, costs of transporting goods from a distribution center to a retail store may be included in a COGS deduction because those costs are deemed to be handling (or inbound transportation) costs. SEE State Tax Automated Research (STAR) Document No. 201101084L (January 1, 2011). SEE ALSO Treas. Reg. SECTION 1.263A-3(c)(4), which defines handling costs to include costs attributable to processing, assembling, repackaging, and transporting goods acquired for resale. These costs include the cost of dispatching trucks, loading and unloading shipments, depreciation on trucks and equipment, and the costs of fuel, insurance, labor and similar costs. Id. Transportation costs that are incurred in transporting goods from a vendor to a taxpayer, between the taxpayer's storage facilities, or from the taxpayer's storage facility to a retail sales facility are treated as allowable handling costs.

However, the COGS deduction does not include costs associated with selling, distribution (including outbound transportation), and rehandling (among other things). Tex. Tax Code Ann. SECTION 171.1012(e). The Comptroller defines distribution costs as any transportation cost incurred outside a storage facility in delivering goods to a customer (and any costs incurred on a loading dock are treated as incurred outside a storage facility). SEE Comptroller's Decision Nos. 108,064 and 108,065 (2013), which cites Treas. Reg. SECTION 1.263A-3(c)(4)(vi)(1). For example, costs incurred outside a retail sales facility in delivering goods to a customer are distribution costs. Id.

The ASTM Standard Specifications for ready-mix concrete notes that concrete mixers can be stationary or mobile (truck mixers). In fact, the ASTM Standard Specifications refer to a mixer truck as a "transportation unit" that delivers freshly mixed, unhardened concrete. [ENDNOTE: (18)] Those guidelines also state that concrete that is completely mixed in a truck mixer generally reaches "uniformity of concrete" after 70 to 100 drum revolutions at the mixing speed designated by the manufacturer. [ENDNOTE: (19)] Petitioner's trucks reach that threshold before leaving the batch plant. Additionally, while there may be a limited ability to adjust for exceptional circumstances, the standards make clear that once the mixer truck leaves the plant water can only be added to the mix at the job site and even then its application is subject to specific limitations. The ALJ finds the ASTM standards instructive and persuasive. They undercut Petitioner's mixer truck arguments because they demonstrate that the product being delivered is fresh, unhardened, concrete, and that the mixer truck serves two purposes. The drum operates to mix (process) the various materials that are used to create usable ready-mix concrete, and the truck itself operates to deliver (transport) the ready-mix concrete to a customer.

It is also clear from the evidence that Petitioner incurred substantial costs transporting ready-mix concrete to its customers, and it acknowledges that the Tax Code does not permit taxpayers to include delivery costs. Because Petitioner did not segregate all of the costs directly associated with the drum from the costs associated with the truck itself, the auditor used her judgment to estimate them. She allowed 30% of all the costs associated with the mixer truck fuel, repairs, maintenance, and depreciation. And though the auditor did not rely on the document, Staff also pointed out that a NRMCA study estimated that a mixer truck's PTO fuel use was approximately 20 to 25% of total fuel use. Staff also pointed out that the truck and mixer invoices in the record support the auditor's determination as well because Petitioner's purchase of a 2006 Kenworth truck was approximately 74% of the overall cost of the mixer truck. The auditor also testified that Petitioner's representatives stated to her that approximately 35% of their truck costs were tied to the mixer and about 65% were tied to the truck. Additionally, it is worth noting that, for motor fuel transactions that took place prior to January 1, 2004, the Comptroller allowed operators of gasoline-powered ready-mix concrete trucks equipped with PTO or auxiliary power units that were mounted on the motor vehicle that used the fuel supply tank of the motor vehicle to claim a refund on the motor fuel tax paid. The refundable amount was 30% of the total gasoline used in this state by each vehicle because the fuel was deemed to have been used, off-highway, by the PTO. 34 Tex. Admin. Code SECTION 3.432(h)(2). The auditor's audit plan notes indicate that her 30% determination may have been influenced by the percentages the Comptroller previously used for gasoline refund claims. [ENDNOTE: (20)] The salient point for purposes of the instant matter is that the auditor's estimated COGS allocation was reasonable and was based on the best information available. SEE Tex. Tax Code Ann. SECTION 111.0042(d), which authorizes estimations when taxpayer records are inadequate to reflect the business operations of a taxpayer.

The ALJ disagrees with Petitioner's assertion that there is no basis in law for allocating its mixer truck costs in the manner used by the auditor. Estimations are specifically authorized by the Tax Code. In fact, the Comptroller uses allocation methodologies similar to those the auditor used when examining other franchise tax transactions. For example, when a transaction contains elements of both a sale of tangible personal property and a service, the costs associated with the service are disallowed and the taxpayer can include only allowable costs associated with the tangible personal property. 34 Tex. Admin. Code SECTION 3.588(c)(7). The costs must be allocated between those that are allowable COGS deductions and those that are not. The auditor's allocation of the processing and delivery costs associated with Petitioner's ready-mix trucks constitutes a reasonable means of achieving the Legislature's intent with respect to the COGS deduction. Additionally, the ALJ finds that the audit determination is reasonable and consistent with the evidence. Petitioner's evidence does not demonstrate that the mixer truck processing costs were more than the auditor allowed; therefore, the ALJ recommends no adjustment to the COGS deduction with respect to costs associated with Petitioner's mixer trucks.

Operator/Driver Labor Costs

The auditor initially disallowed 85% of the costs associated with operator/drivers. Her determination was based on a review of the documents Petitioner provided that described the duties and time an operator/driver spent on a job. The auditor agreed that an operator/driver was spending a portion of his time directly engaged in manufacturing concrete; however, she determined that 85% of his time was spent delivering or rehandling the product. For example, using the 2010 numbers Petitioner provided, the auditor estimated that the driver spent 18.2 of 118 minutes manufacturing concrete. After touring Petitioner's facilities, the auditor agreed to allow the operator/driver load time, the unload time, and the wash down time. Her revised determination is that 41% of the costs associated with operator/drivers should be disallowed. The disallowed portion relates to the estimated time that is spent driving to and from the job site, which she determined was a delivery or rehandling cost. As it did with the costs associated with its mixer trucks, Petitioner argues that it is entitled to deduct 100% of its operator/driver costs.

Petitioner's contention is similar to its mixer truck argument; I.E. processing is taking place throughout the journey from Petitioner's facility to the customer's job site. Petitioner correctly points out that the operator/driver is responsible for the product and occasionally has to add water or make other adjustments to ensure that the cement meets the customer's specification. But, as with its mixer trucks, the operator/drivers are serving two purposes: they are participating in the processing of ready-mix cement and in the delivery of the product to the customer. Based on the reasoning previously discussed, those costs should be allocated accordingly. The auditor's estimated allocation of the operator/driver labor costs is reasonable and consistent with the evidentiary record, and Petitioner's evidence does not demonstrate that the operator/driver labor costs associated with processing ready-mix cement were more than the auditor allowed.

For example, Petitioner argues that the auditor erroneously determined that the trip from the job site back to the batch plant was a rehandling cost. Petitioner states that the material remaining in the drum is not a finished good. Staff disagrees and argues that the continually rotating drum is serving a rehandling or maintenance purpose. The evidence demonstrates that product remaining in the drum can be redirected to a second customer, combined with another order at the batch plant, poured into blocks for sale, or hardened and crushed for sale as aggregate. In each of those instances, the product is being rehandled for resale and costs associated with that purpose are properly excluded from the COGS deduction.

In some instances residual amounts are simply washed out of the drum, which is a maintenance activity. A taxable entity may include in its COGS calculation the costs of repairing and maintaining equipment, facilities, or real property directly used for the production of goods. 34 Tex. Admin. Code SECTION 3.588(d)(8). Thus, the operator/driver costs associated with final washout of the drum are includable in the COGS deduction. Staff states that its allocation includes those costs, and Petitioner's evidence does not demonstrate that Staff's assertion is incorrect. Therefore, the ALJ recommends no adjustment to the COGS deduction with respect to labor costs associated operator/drivers.

Dispatcher Labor Costs

Initially, the auditor disallowed the labor costs associated with Petitioner's dispatcher. The auditor ultimately changed her mind and allowed costs associated with dispatchers. However, they were designated as indirect or administrative service costs, which are capped at 4% of the total indirect and administrative overhead cost. Petitioner argues that its dispatcher costs are not indirect service costs. The ALJ agrees.

A taxable entity may subtract as a COGS service costs that it can demonstrate are reasonably allocable to the acquisition or production of goods, but the amount subtracted may not exceed 4% of the total indirect and administrative overhead costs. 34 Tex. Admin. Code SECTION 3.588(f). For purposes of the COGS deduction, a service department includes: personnel (including costs of recruiting, hiring, relocating, assigning, and 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. 34 Tex. Admin. Code SECTION 3.588(b)(9). The evidence demonstrates that Petitioner's dispatchers received and routed orders, received communications from customers and drivers, and adjusted mixer truck routes when necessitated by unexpected conditions such as traffic accidents. Those duties are not at all similar to those the Comptroller's rule lists as service costs allowable as indirect service costs.

The Comptroller's Tax Policy Division recently published guidance stating that indirect labor costs that directly relate to the production or acquisition and resale activities (and are not service costs) may be fully included in the COGS deduction under Texas Administrative Code SECTION 3.588(d)(1). STAR Document No. 201307727L, July 16, 2013. The example cited by the Tax Policy Division is the salary and benefits paid to the head of a production division at a plant. At least a portion of the job duties performed by Petitioner's dispatchers appear to fall into this category.

However, as the ALJ previously stated, the Comptroller has also relied on federal tax law provisions in defining allowable COGS deductions. Federal regulations specifically include costs of dispatching trucks with costs associated with transportation. Treas. Reg. SECTION 1.263A-3(c)(4)(v). Allowable transportation (inbound) costs include costs incurred in transporting property from a vendor to a taxpayer, for example. However, transportation costs that are incurred in delivering goods to a customer are distribution costs. Treas. Reg. SECTION 1.263A-3(c)(4)(vi). As the Comptroller previously held, the distinction between allowable transportation costs and non-allowable distribution costs is that transportation costs take place after the sale are considered distribution costs. SEE Comptroller's Decision Nos. 108,064 and 108,065 (2013). Some portion of the costs associated with Petitioner's dispatchers relate to events that take place after the sale of ready-mix concrete, which cannot be included in the COGS deduction. As with the other issues in this case, Petitioner's records do not differentiate allowable indirect production costs from unallowable distribution costs. Staff has made a concession on the issue, and the ALJ recommends that the Comptroller adopt that concession in her final decision. But the ALJ finds that there is no basis for allowing Petitioner to claim dispatcher costs beyond what Staff conceded. [ENDNOTE: (21)]

III. FINDINGS OF FACT

1. ************* (Petitioner) is a national company that manufactures and sells concrete products. It has facilities in the CITY metroplex and also in west Texas.

2. Each facility stores various components of ready-mix concrete (E.G., stone, sand, chemicals, water), but not every facility stores every component that might be used.

3. Petitioner also owns a fleet of ready-mix concrete trucks that are used to manufacture and deliver ready-mix concrete to Petitioner's customers.

4. Generally, Petitioner's concrete mixer trucks are ordered in two steps. First, Petitioner must select a truck manufacturer, E.G., Mack, Freightliner, or Kenworth. For example, in 2006, Petitioner placed an order for eight Kenworth trucks that cost $************* each (after including taxes and fees). The trucks are specifically designed to meet Petitioner's needs.

5. Once the trucks are manufactured they are delivered to a concrete drum manufacturer, E.G., McNeilus. The drum manufacturer will outfit the truck with a mixer drum. Internally, the drum has fins and blades that assist the concrete manufacturing process. It must be placed on the truck at a specific angle and height to perform correctly.

6. The drum manufacturer must also add controllers (joysticks) at the back of the truck and inside the cab. The controllers allow the operator/driver to control the drum rotation speeds and track drum rotations. In 2006, McNeilus outfitted one of Petitioner's trucks for $*************.

7. The drum and equipment that is used to operate the drum is generally referred to as "power takeoff" (PTO) equipment.

8. Filling a customer's ready-mix concrete order begins with Petitioner's dispatcher.

9. The dispatcher will record various customer specifications for the concrete and determine which of Petitioner's facilities is most appropriate for completing the order.

10. The dispatcher will consider factors such as the location of the job site and materials availability.

11. Different plants have different materials on-hand.

12. The dispatcher and the operator/driver will need to estimate the amount of time it will take to travel from the plant to the job site.

13. Petitioner's dispatchers received and routed orders, received communications from customers and drivers and adjusted mixer truck routes when necessitated by unexpected conditions such as traffic accidents.

14. Petitioner tries to locate its facilities such that they are within a 15 to 20 mile radius of one another, because the life span of its product is about 90 minutes.

15. Travel time from the plant to the job site is a critical component in Petitioner's manufacturing operation.

16. The distance factor is also important because Petitioner's ready-mix cement truck fleet is comprised of vehicles that are designed to make hauls that average no more than 20 to 25 miles.

17. Once the dispatcher assigns the job to a facility, an operator/driver begins his tasks.

18. Petitioner describes the various tasks that an operator/driver performs as follows:

Loading:
* Driver pushes the "in service" button on the truck computer,
* Delivery ticket is sent to the plant,
* Driver pulls under the loader/hopper and plant dispenses materials into the turning mixer drum,
* Driver rinses down the rear of the truck and checks slump of the concrete,
* Driver adds water as necessary to reach the proper slump at the plant.

To Jobsite:
* Driver leaves the plant and drives to the job site,
* Mixer is still mixing the concrete to achieve the correct slump at the job site,
* Driver is responsible for ensuring revolutions to customer specifications,
* Driver may need to adjust the slump.

Unloading:
* Driver waits until customer is ready to pour out the concrete,
* Driver reverses the turning drum to discharge the concrete down the chute,
* Concrete is poured into a wheel barrel for slump tests,
* Customer may reject load if slump test does not meet required specifications,
* Accepted concrete is poured into forms or pumps at the customer site.

Washout:
* Driver has completed the pour and has reversed the direction of the drum,
* Proceeds to the wash down area where the rear of the truck and chutes are cleaned.

To Plant:
* Driver returns to a plant to get another load or docks out,
* If usable concrete is left in the drum, it may be layered on for another load or used to create retaining wall bricks.

19. Petitioner developed a driver-time metric that showed the average time that its drivers spent performing various tasks. For example, in 2010, the average times, in minutes, were: load time, 18; travel to job time, 22; unload time, 37; washout time, 15; and travel to plant time, 26; for a total job average of

118 minutes.

20. When the ready-mix concrete component materials are being loaded into the truck's drum the operator must ensure that the drum is turning at a very fast rate, a mixing speed.

21. Once the various components are loaded into the truck drum, the operator/driver will climb a rack and look in to the drum to check the consistency and workability (slump) of the mix, because the slump of the mix is one of the specifications customers make when they order concrete.

22. The operator/driver is trained and knows that concrete slump is not static; it will change over time and the rate of change will fluctuate based on temperatures and concrete components. For example, if it is a particularly hot day the operator might add extra water to the drum mixture.

23. The operator/driver must use his experience and judgment to know how much water to add so that the mix will be at the customer-ordered slump when the concrete is delivered at the job site.

24. Concrete that is completely mixed in a truck mixer will generally be at a uniform consistency after 70 to 100 drum revolutions at mixer speeds.

25. Once the operator/driver is satisfied with the product in the drum, he will slow the drum to an agitator speed and proceed to the job site.

26. Occasionally, the operator/driver's arrival at a job site is delayed. In those instances, he will have to radio the dispatcher to reroute trucks that may be following.

27. The initial slump determination is based on an estimated arrival time. If the initial estimate is significantly wrong, then adjustments will have to be made.

28. No water from the truck water system or elsewhere shall be added after the initial introduction of mixing water for the batch except when on arrival at the job site the slump of the concrete is less than that specified by the customer.

29. If the desired slump is less than specified, and except where otherwise specified, the desired slump can be obtained with a one-time addition of water. A one-time addition of water is not prohibited from being several distinct additions of water provided no concrete has been discharged except for slump testing. All water additions shall be completed within 15 minutes from the start of the first water addition, and such additional water shall be injected into the mixer under such pressure and direction of flow to allow for proper distribution within the mixer.

30. The drum shall be turned an additional 30 revolutions, or more if necessary, at mixing speed to ensure that a homogenous mixture is attained. Water shall not be added to the batch at any later time.

31. Discharge of the concrete shall be completed within 1½ hours or before the drum has made 300 revolutions, whichever comes first, after the introduction of the mixing water. These limitations are permitted to be waived by the purchaser if the concrete slump is such that it can be placed, without the addition of water, to the batch. In hot weather, or under conditions that contribute to quick stiffening of the concrete, a time less than 1½ hours is permitted to be specified.

32. Once the customer approves the load, the operator/driver will reverse the spin of the drum and begin offloading the concrete, which may require him to move the truck periodically.

33. When the order is complete the operator/driver will wash down the truck and proceed back to the plant.

34. At the end of the day, the operator/driver will washout the drum.

35. Only when the day is complete and the drum is clean does the operator/driver stop the drum. From the beginning of the process to the final washout, the drum has been spinning.

36. If the drum stops spinning prior to final wash out, the concrete mix components will separate or begin setting-up in the drum.

37. Product remaining in the drum of a mixer truck after a delivery is made can be redirected to a second customer, combined with another order at the batch plant, poured into blocks for sale, or hardened and crushed for sale as aggregate. Residual product can also be simply washed out of the drum to help maintain the drum in proper working order.

38. For franchise tax report years 2008 and 2009, Petitioner filed a Texas Franchise Tax Report that calculated its taxable margin utilizing the cost of goods sold (COGS) deduction. The COGS deduction included 100% of Petitioner's mixer truck costs, 100% of its operator/driver salaries, and 100% of its dispatcher salaries.

39. The Comptroller's auditor met with Petitioner's representatives and reviewed various business records. She determined that a portion of the COGS deduction should be disallowed.

40. Petitioner's mixer trucks serve two purposes. The drum operates to process the various materials that are used to create usable ready-mix concrete. The truck itself operates to deliver the ready-mix concrete to a customer.

41. The auditor disallowed 70% of the mixer truck costs. She allowed 30% of all the costs associated with the mixer truck fuel, repairs, maintenance, and depreciation.

42. A National Ready Mixed Concrete Association (NRMCA) study estimated that a mixer truck's PTO fuel use was approximately 20 to 25% of total fuel use.

43. Truck and mixer invoices in the record demonstrate that Petitioner's purchase of a 2006 Kenworth truck was approximately 74% of the overall cost of the mixer truck.

44. Petitioner's representatives told the auditor that approximately 35% of their truck costs were tied to the mixer, and about 65% were tied to the truck.

45. The auditor initially disallowed 85% of the operator/driver salaries. For example, using the 2010 numbers Petitioner provided, the auditor initially estimated that the driver spent 18.2 of 118 minutes manufacturing concrete.

46. The auditor took a tour of Petitioner's facility and revised her COGS recommendation to disallow 41% of the operator/driver costs (as opposed to the previous 85%). The auditor agreed to allow the operator/driver load time, the unload time, and the wash down time. The disallowed portion relates to the time spent driving to and from the job site, which she determined was a delivery or rehandling cost.

47. The auditor initially disallowed labor costs associated with Petitioner's dispatchers.

48. The auditor ultimately allowed costs associated with dispatchers. However, they were designated as indirect or administrative costs, which are capped at 4% of the total indirect and administrative overhead cost.

49. Staff referred the cases to the State Office of Administrative Hearings (SOAH) and, on August 12, 2013, Staff issued Notices of Hearing that contained the date, time, and location of the hearing; a statement of the nature of the hearing; a statement of the legal authority and jurisdiction under which the hearing was to be held; a reference to the particular sections of the statutes and rules involved; and a short, plain statement of the matters asserted.

50. The Administrative Law Judge (ALJ) convened a hearing on the merits on January 14, 2014.

51. The record for each contested case closed on February 25, 2014.

52. Except for the initial purchase costs, nothing in the record demonstrates that Petitioner separately recorded mixer drum and truck costs to differentiate costs related to processing and delivery.

53. Nothing in the record demonstrates that Petitioner separately recorded the operator/driver labor charges to differentiate costs related to processing and delivery.

IV. CONCLUSIONS OF LAW

1. The Comptroller has jurisdiction over this matter pursuant to Texas Tax Code ch. 111.

2. SOAH has jurisdiction over matters related to the hearing in this matter, including the authority to issue a proposal for decision with findings of fact and conclusions of law pursuant to Texas Government Code ch. 2003.

3. The Comptroller provided proper and timely notice of the hearing pursuant to Texas Government Code ch. 2001.

4. Franchise tax is imposed on each corporation that does business in this state or that is chartered or organized in this state. Tex. Tax Code Ann. SECTION 171.001.

5. The taxable margin of a taxable entity is determined by calculating 70% of total revenue from the entity's total business, or by subtracting, at the election of the taxpayer, either the COGS or compensation. SEE Tex. Tax Code Ann. SECTION 171.101(a)(1), .1011, .1012, and .1013.

6. With respect to the COGS methodology, the Tax Code defines "goods" as real or tangible personal property sold in the regular course of business, and services are specifically excluded. SEE Tex. Tax Code Ann. SECTION 171.1012(a)(1) and 1012(a)(3)(B)(ii).

7. To prevail in the instant matter, Petitioner must demonstrate by a preponderance of evidence that the auditor erred. 34 Tex. Admin. Code SECTION 1.40(2)(B).

8. The COGS includes all direct costs of acquiring or producing goods, including (but not limited to): labor costs, costs of materials that are an integral part of the specific property being produced, costs of materials that

are consumed in the ordinary course of performing production activities, handling costs (including costs attributable to processing, assembling, repackaging, and inbound transportation costs), and depreciation. Tex. Tax Code Ann. SECTION 171.1012(c).

9. Costs of transporting goods from a distribution center to a retail store may be included in a COGS deduction, because those costs are deemed to be handling (or inbound transportation) costs. SEE State Tax Automated Research (STAR) Document No. 201101084L (January 1, 2011). SEE ALSO Treas. Reg. SECTION 1.263A-3(c)(4), which defines handling costs to include costs attributable to processing, assembling, repackaging, and transporting goods acquired for resale. These costs include the cost of dispatching trucks, loading and unloading shipments, depreciation on trucks and equipment, and the costs of fuel, insurance, labor and similar costs. Id.

10. Costs are that transportation costs that are incurred in transporting goods from a vendor to a taxpayer, between the taxpayer's storage facilities, or from the taxpayer's storage facility to a retail sales facility are treated as allowable handling costs.

11. Direct costs associated with Petitioner's ready-mix drums are properly included in a COGS deduction calculation.

12. The COGS deduction does not include costs associated with selling, distribution (including outbound transportation), and rehandling (among other things). Tex. Tax Code Ann. SECTION 171.1012(e).

13. The Comptroller defines distribution costs any transportation cost incurred outside a storage facility in delivering goods to a customer (and any costs incurred on a loading dock are treated as incurred outside a storage facility). SEE Comptroller's Decision Nos. 108,064 and 108,065 (2013), which cite Treas. Reg. SECTION 1.263A-3(c)(4)(vi)(1).

14. Costs incurred outside a retail sales facility in delivering goods to a customer are distribution costs. Id.

15. When construing a statute, the primary objective is to ascertain and give effect to the Legislature's intent. SEE FIRST AM. TITLE INS. CO. V. COMBS, 258 S.W.3d 627, 631-32 (Tex. 2008).

16. The statute is considered as a whole with each word being read in context rather than in isolation, and unless a different definition is supplied by the Legislature, courts assume the words chosen have their plain and ordinary meaning. SEE CITY OF ROCKWELL V. HUGHES, 246 S.W.3d 621, 625-26 (Tex. 2008).

17. For purposes of statutory construction, Texas courts treat a deduction as tantamount to an exemption and therefore construe Texas Tax Code provisions strictly against the taxpayer and in favor of the taxing authority. SEE TEXAS UTILS. ELEC. CO. V. SHARP , 962 S.W.2d 723, 726 (Tex. App.—Austin 1998).

18. When a transaction contains elements of both a sale of tangible personal property and a service, the costs associated with the service are disallowed and the taxpayer can include only allowable costs associated with the tangible personal property. 34 Tex. Admin. Code SECTION 3.588(c)(7).

19. Differentiating the processing and delivery costs associated with ready-mix trucks is a reasonable means of achieving the Legislature's intent with respect to the COGS deduction.

20. Petitioner's evidence does not demonstrate that the mixer truck processing

costs were greater than the auditor allowed.

21. Petitioner's evidence does not demonstrate that the operator/driver labor costs associated with processing ready-mix cement were more than the auditor allowed.

22. Ready-mix cement product that remains in a mixer truck drum after an order is completed is properly included in a COGS deduction when the residual product is simply washed out for maintenance purposes. SEE 34 Tex. Admin. Code SECTION 3.588(d)(8), which provides that a taxable entity may include in its COGS calculation the costs of repairing and maintaining equipment, facilities, or real property directly used for the production of goods.

23. Petitioner's evidence does not differentiate the costs associated with the various end-use possibilities for product remaining in its mixer trucks after completing a delivery.

24. A taxable entity may subtract as a COGS service costs that it can demonstrate are reasonably allocable to the acquisition or production of goods, but the amount subtracted may not exceed 4% of the total indirect and administrative overhead costs. 34 Tex. Admin. Code SECTION 3.588(f).

25. For purposes of the COGS deduction, a service department includes: personnel (including costs of recruiting, hiring, relocating, assigning, and 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. 34 Tex. Admin. Code SECTION 3.588(b)(9).

26. Indirect labor costs that directly relate to production or acquisition and resale activities (and are not service costs) may be fully included in the COGS deduction under Texas Administrative Code SECTION 3.588(d)(1). STAR Document No. 201307727L, July 16, 2013.

27. Federal regulations specifically include costs of dispatching trucks with costs associated with transportation. Treas. Reg. SECTION 1.263A-3(c)(4)(v).

28. Allowable transportation (inbound) costs include costs incurred in transporting property from a vendor to a taxpayer, for example. However, transportation costs that are incurred in delivering goods to a customer are distribution costs. Treas. Reg. SECTION 1.263A-3(c)(4)(vi).

29. The distinction between allowable transportation costs and non-allowable distribution costs is that transportation costs that take place after the sale are considered distribution costs. SEE Comptroller's Decision Nos. 108,064 and 108,065 (2013).

30. A portion of the costs associated with Petitioner's dispatchers relate to events that take place after the sale of ready-mix concrete.

31. In this case Staff has made a concession on the dispatcher costs issue and the ALJ recommends that the Comptroller adopt that concession in her final decision. But the ALJ finds that there is no basis for allowing Petitioner to claim dispatcher costs beyond what Staff conceded.

32. Except as agreed by Staff, Petitioner failed to meet its burden to demonstrate that the assessments at issue are erroneous. SEE 34 Tex. Admin. Code SECTION 1.40(2)(B).

33. The audit assessment should be affirmed except as agreed by Staff.

Hearing Nos. 108,959; 108,960

ORDER OF THE COMPTROLLER

On March 3, 2014, the State Office of Administrative Hearings' Administrative Law Judge (ALJ), Victor John Simonds, issued a Proposal for Decision in the above-referenced matters to which Petitioner filed Exceptions on March 20, 2014. The Tax Division filed a Response on March 27, 2014. The Comptroller has considered the Exceptions, Response and the ALJ's recommendation letter and determined that the ALJ's Proposal for Decision, except for minor changes to correct typographical or clerical errors, should be adopted without change and this Decision represents the ruling thereon.

The above Decision resulting in Petitioner's liabilities as set out in Attachments A, which are incorporated by reference, is approved and adopted in all respects. The Decision becomes final twenty days after the date Petitioner receives notice of this decision, and the total sum of the tax, penalty, and interest amounts is due and payable within twenty days thereafter. If such sum is not paid within such time, an additional penalty of ten percent of the taxes due will accrue, and interest will continue to accrue. If either party desires a rehearing, that party must file a motion for rehearing, which must state the grounds for rehearing, no later than twenty days after the date Petitioner receives notice of this Decision. Notice of this Decision is presumed to occur on the third day after the date of this Decision.

Signed on this 26th day of September 2014.

SUSAN COMBS
Texas Comptroller of Public Accounts

by: Martin A. Hubert
Deputy Comptroller

ENDNOTE(S)
(1) Petitioner Hearing Exhibit No. 25 at paragraph 3.2.2, and Staff Hearing Exhibit No. 10 at paragraph 1.1.

(2) Staff Hearing Exhibit No. 10 and Petitioner Exhibit No. 25 at paragraph 4.1.

(3) Staff Hearing Exhibit No. 9.

(4) Hearing Testimony 2 at 1:08:00.

(5) Hearing Testimony 2 at 1:10:00.

(6) Staff Hearing Exhibit No. 9.

(7) Hearing Testimony 2 at 1:41:00.

(8) Hearing Testimony 2 at 1:41:30.

(9) Hearing Testimony 2 at 1:42:00.

(10) Hearing Testimony 2 at 1:05:00.

(11) Hearing Testimony 2 at 1:05:00.

(12) Staff Exhibit No. 10 at paragraph 12.5.

(13) Staff Hearing Exhibit No. 10 at paragraph 12.7.

(14) Id.

(15) Hearing Testimony 2 at 0:42:00.

(16) Hearing Testimony 2 at 0:43:00.

(17) Prior to proposing the above-referenced amended audit numbers, Staff and the auditor prepared draft amended schedules that utilized different COGS percentages. The auditor testified about the interim schedules and they are part of the record. However, their relevance to the case is minimal because Staff and the auditor abandoned both the interim numbers and the legal theories that may have supported those adjustments. That, plus the fact that the case is extremely fact intense even in the absence of the interim schedules, led the ALJ to conclude that they should not be addressed within the PFD.

(18) Staff Hearing Exhibit No. 10 and Petitioner Hearing Exhibit No. 25 at paragraph 4, for example.

(19) Staff Hearing Exhibit No. 10 and Petitioner Hearing Exhibit No. 25 at paragraph 12.5.

(20) "When they file for a fuel tax refund, the part that's not refunded would be given. It is still considered outbound transportation and not allowed." Staff Exhibit No. 5 at page 9.

(21) Petitioner argues that COMBS V. NEWPARK RES. INC., No. 03-12-00515-CV, 2013 Tex. App. LEXIS 15455 (Tex. App.—Austin Dec. 31, 2013, reh. den.) demonstrates that it is entitled to 100% of its COGS deduction. The ALJ disagrees. The instant matter and NEWPARK both involve Texas franchise tax and the COGS deduction, but that is where the similarities end. NEWPARK related to oilfield services and drilling mud, and the legal issue was whether costs related to the disposal of waste material by a NEWPARK subsidiary qualified as a COGS deduction. Resolution of the dispute turned on issues related to the NEWPARK combined group and whether the subsidiary could furnish labor or materials to a project for the construction of real property such that NEWPARK could include the costs in a COGS deduction. The Court answered yes. However, the Court stated that the expenses at issue qualified under Texas Tax Code SECTION 171.1012(i), which relates to real property construction projects. The Court states very clearly that the expenses did not fit into any of the costs that can be deducted under Texas Tax Code SECTION 171.1012(c) or (d). Texas Tax Code SECTION 171.1012(i) has no applicability to the contested case. Thus, the facts and law at issue in NEWPARK are too dissimilar from those of the contested case to be controlling or instructive in resolving the contested case issues.

ACCESSION NUMBER: 201409972H
SUPERSEDED: N
DOCUMENT TYPE: H
DATE: 09/26/2014
TAX TYPE: FRANCHISE

201504069L

Date: April 23, 2015

To: Denise Stewart, Director, Audit Division

From: Teresa Bostick, Director, Tax Policy Division

**Subject:** Tax Code Section 171.1012(c)(9) - Cost of Goods Sold for Research, Experimental, Engineering, and Design Activities

### Issue

Whether a taxable entity that is not the producer of goods it sells, because it contracts out the manufacturing of the product, can include in costs of goods sold (COGS) expenses for research, experimental, engineering, and design activities related to those products.

### Relevant Authorities

Texas Tax Code Section171.1012(c)(9) Internal Revenue Code Section 174 Treas. Regs. Section1.174-1 through 1.174-4

### Discussion

Tax Code Section171.1012(c)(9) states, "the cost of goods sold includes all direct costs of acquiring or producing goods, including costs attributable to research, experimental, engineering, and design activities directly related to the production of the goods, including all research or experimental expenditures described by Section 174, Internal Revenue Code (IRC)."

Under prior policy COGS deductions for a taxable entity that was not the producer of the goods were limited to acquisition, storage, handling, and other costs specified in Tax Code Section171.1012(c) and (d) not related to production. Costs directly related to the production of goods that were typically allowed to a producer, such as research, experimental, engineering, and design activity costs, were not allowed as a COGS deduction for a taxable entity that was not the producer of the goods.

Upon further review, Tax Policy determined that a taxable entity who is eligible for COGS may claim as COGS all research and experimental costs described by Section 174 of the IRC, regardless of whether the taxable entity is considered the producer of the goods.

Section 174 of the IRC does not define research and experimental *costs*; however, related Treas. Reg. Section1.174-2 does provide a definition of research and experimental *expenditures*. Treas. Reg. Section1.174-2(a)(1) states, "The term *research or experimental expenditures*, as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense." Treas. Reg. Sections1.174-2(a)(1)-(2) also describe what costs are generally included in the term *research and experimental expenditures* and "...includes all such costs incident to the development or improvement of a product."

Based on these authorities, regardless of whether the taxable entity is the producer of the good or not, the taxable entity may include in its COGS deduction research, experimental, engineering, and design activity costs, including all research or experimental expenditures described by Section 174 of the IRC relating to goods it sells.

This policy is effective for all open periods within the statute of limitations and future periods.

ACCESSION NUMBER: 201504069L
SUPERSEDED: N
DOCUMENT TYPE: L
DATE: 04/24/2015
TAX TYPE: Franchise

201606856L

DATE: June 30, 2016

TO: Denise Stewart, Audit Division
Jim Arbogast, General Counsel

FROM: Teresa Bostick, Tax Policy Division

SUBJECT: Policy change based on TITAN and NEWPARK

Note: This memo supersedes the June 10, 2014 memo (201406920L) on the interpretation of "mandated by contract" as provided in Tax Code Section 171.1011(g). The policy was overturned in *Titan Transp., LP v. Combs*, 433 S.W.3d 625 (Tex.App.—Austin 2014, pet. denied).

ISSUE

Based on the courts' language and analysis in TITAN and NEWPARK, we are revising the policy with regard to payments eligible for exclusion under Section 171.1011(g) and qualifying activities for the COGS deduction under Section 171.1012(i).

BACKGROUND

The court in TITAN found that Titan Transportation, L.P. (Titan), which is in the business of hauling, delivering, and depositing aggregate at real property construction sites, was entitled to exclude from revenue, pursuant to Section 171.1011(g)(3), payments the taxpayer made to its subcontractors providing this service for its customers.

Newpark Resources, Inc. (Newpark), an oil field service business, was the reporting entity for a combined group which included its subsidiary, Newpark Environmental Services, L.L.C. (NES). The court in NEWPARK found that Newpark was entitled to take a COGS deduction under Section 171.1012(i) for NES's activities of removal and disposal of waste materials from oil and gas well drilling sites.

REVISED POLICY

This change has immediate effect and a taxable entity may file an amended franchise tax report for years that are open within the statute of limitations.

Section 171.1011(g) states, "A taxable entity shall exclude from its total revenue…only the following flow-through funds that are mandated by contract to be distributed to other entities:…"

According to the Third Court of Appeals, the term "other entities," as used in Section 171.1011(g), merely means someone other than the taxable entity. The court explained the "purpose of the (g)(3) revenue exclusion is to prevent double taxation of funds that are not truly gain or income to the taxpayer, and this purpose is satisfied regardless of whether the mandate is contained in a contract with a customer or with a subcontractor." *Titan Transp., LP v. Combs*, 433 S.W.3d 625, 641 (Tex. App. Austin 2014, pet. denied).

Under the revised policy, a payment is mandated by contract to be distributed to other entities and qualifies as flow-through funds under Section 171.1011(g) if the taxable entity has a contract with its customer providing that a subcontractor may be used and requiring payment to the subcontractor, or by a written contract between the taxable entity and the subcontractor where the payment is based on the funds paid to the taxable entity by the taxable entity's customers. For example, the contract between the taxable entity and the subcontractor require payment based on a percentage of the funds the taxable entity receives from its customer. The timing of the payments does not determine if a payment qualifies as a flow-through fund.

Further, payments which qualify as flow-through funds under Section 171.1011(g) and have a reasonable nexus to the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of boundaries of real property, may be excluded from revenue pursuant to Section 171.1011(g)(3).

With regard to COGS, Section 171.1012(i) states, "A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance of real property is considered to be an owner of that labor or materials and may include the costs, as allowed by this section, in the computation of costs of goods sold."

Under the revised policy, we are expanding the interpretation of what is considered to be furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance of real property and will no longer require an entity to actually physically touch the property or make a change to the property to qualify for the COGS deduction.

The policy changes are similar for both Sections 171.1011(g)(3) and 171.1012(i), but with one slight difference. The policy for both Sections will permit industries such as transportation companies delivering aggregate and other similar materials to a construction site, waste removal companies, demolition companies, and inspectors, among others, to claim either a COGS deduction or an exclusion from revenue – provided the transaction meets the contractual requirement of flow-through funds as described above. The one slight difference is that Section 171.1011(g)(3) uses the term "proposed" – absent from Section 171.1012(i) – which may permit costs for activities performed by architects and engineers to qualify as exclusions from revenue, without regard to whether construction occurs.

Costs considered too far removed from the construction, improvement, remodeling, repair, or industrial maintenance of real property do not qualify for either an exclusion from revenue or a COGS deduction. For example, entities providing services that are defined as "service costs" under Rule 3.588(b)(9), such as legal services and accounting services, are too far removed and do not qualify for either an exclusion from revenue or a COGS deduction.

Further, the revised policy does not change the treatment of taxable entities renting or leasing equipment to others for use in or during such projects. Section 171.1012(k-1) still limits the COGS deduction to taxpayers renting or leasing certain items to others. Taxpayers who rent or lease equipment other than heavy construction equipment, such as fencing or port-a-potties, to others for use in projects for the construction, improvement, remodeling, repair or industrial maintenance of real property, are not eligible for the COGS deduction under Section 171.1012.

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Comptroller of Public Accounts FORM 05-158-A (Rev.9-11/6)

**Tcode** 13250 Annual

# Texas Franchise Tax Report - Page 1

| Taxpayer number | Report year | Due date | Privilege period covered by this report |
|---|---|---|---|
| | 2 0 0 9 | 05/15/2009 | 01/01/2009 — 12/31/2009 |

| | | | | | |
|---|---|---|---|---|---|
| Taxpayer Name | | | | | Secretary of State file number or Comptroller file number |
| Mailing address | | | | | |
| City | State | Country | ZIP Code | Plus 4 | Blacken circle if the address has changed ○ |

Blacken circle if this is a combined report ○ | Blacken circle if Total Revenue is adjusted for Tiered Partnership Election, see instructions ○

Blacken circle if this is a Corporation or Limited Liability Company ○ | Blacken circle if this is an Entity other than a Corporation or Limited Liability Company ○

** If not twelve months, see instructions for annualized revenue

| Accounting year begin date** (m m d d y y) | Accounting year end date (m m d d y y) | SIC code | NAICS code |
|---|---|---|---|
| | | | |

## REVENUE *(Whole dollars only)*

| | | |
|---|---|---|
| 1. **Gross receipts or sales** | 1. | .00 |
| 2. **Dividends** | 2. | .00 |
| 3. **Interest** | 3. | .00 |
| 4. **Rents** *(can be negative amount)* | 4. | .00 |
| 5. **Royalties** | 5. | .00 |
| 6. **Gains/losses** *(can be negative amount)* | 6. | .00 |
| 7. **Other income** *(can be negative amount)* | 7. | .00 |
| 8. **Total gross revenue** *(Add items 1 thru 7)* | 8. | .00 |
| 9. **Exclusions from gross revenue** *(see instructions)* | 9. | .00 |
| 10. **TOTAL REVENUE** *(item 8 minus item 9 if less than zero, enter 0)* | 10. | .00 |

## COST OF GOODS SOLD *(Whole dollars only)*

| | | |
|---|---|---|
| 11. **Cost of goods sold** | 11. | .00 |
| 12. **Indirect or administrative overhead costs** *(Limited to 4%)* | 12. | .00 |
| 13. **Other** *(see instructions)* | 13. | .00 |
| 14. **TOTAL COST OF GOODS SOLD** *(Add items 11 thru 13)* | 14. | 0.00 |

## COMPENSATION *(Whole dollars only)*

| | | |
|---|---|---|
| 15. **Wages and cash compensation** | 15. | .00 |
| 16. **Employee benefits** | 16. | .00 |
| 17. **Other** *(see instructions)* | 17. | .00 |
| 18. **TOTAL COMPENSATION** *(Add items 15 thru 17)* | 18. | 0.00 |

**Texas Comptroller Official Use Only**

| | |
|---|---|
| VE/DE | ○ |
| PM Date | |

Comptroller of Public Accounts FORM 05-158-B (Rev.9-11/6)

■ Tcode 13251 Annual

# Texas Franchise Tax Report - Page 2

| ■ Taxpayer number | ■ Report year | Due date | Taxpayer name |
|---|---|---|---|
| | 2 0 0 9 | 05/15/2009 | |

**MARGIN** *(Whole dollars only)*

| | | | |
|---|---|---|---|
| **19. Revenue** *(item 10 X 70%)* | 19. ■ | | 00 |
| **20. Revenue** *(item 10 minus item 14 COGS)* | 20. ■ | | 00 |
| **21. Revenue** *(item 10 minus item 18 Compensation)* | 21. ■ | | 00 |
| **22. MARGIN** *(Enter the lowest amount from item 19, 20 or 21)* | 22. ■ | | 00 |

**APPORTIONMENT FACTOR**

| | | | |
|---|---|---|---|
| **23. Gross receipts in Texas** *(Whole dollars only)* | 23. ■ | | 00 |
| **24. Gross receipts everywhere** *(Whole dollars only)* | 24. ■ | | 00 |
| **25. APPORTIONMENT FACTOR** *(Divide item 23 by item 24, round to 4 decimal places)* | 25. ■ | | |

**TAXABLE MARGIN** *(Whole dollars only)*

| | | | |
|---|---|---|---|
| **26. Apportioned margin** *(Multiply item 22 by item 25)* | 26. ■ | | 00 |
| **27. Allowable deductions** *(see instructions)* | 27. ■ | | 00 |
| **28. TAXABLE MARGIN** *(item 26 minus item 27)* | 28. ■ | | 00 |

**TAX DUE**

| | | |
|---|---|---|
| **29. Tax rate** *(see instructions for determining the appropriate tax rate)* | 29. ■ | |
| **30. Tax due** *(Multiply item 28 by the tax rate in item 29) (Dollars and cents)* | 30. ■ | |

**TAX ADJUSTMENTS** *(Dollars and cents) (Do not include prior payments)*

| | | |
|---|---|---|
| **31. Tax credits** *(item 23 from **Form 05-160**)* | 31. ■ | |
| **32. Tax due before discount** *(item 30 minus item 31)* | 32. ■ | |
| **33. Discount** *(See instructions)* | 33. ■ | |

**TOTAL TAX DUE** *(Dollars and cents)*

| | | |
|---|---|---|
| **34. TOTAL TAX DUE** *(item 32 minus item 33)* | 34. ■ | |

**Do not include payment if item 34 is less than $1,000** or if annualized total revenue is less than the no tax due threshold (see instructions). If the entity makes a tiered partnership election, ANY amount in item 34 is due. Complete Form 05-170 if making a payment.

| Print or type name | | Area code and phone number ( ) - |
|---|---|---|
| I declare that the information in this document and any attachments is true and correct to the best of my knowledge and belief. | | **Mail original to:** Texas Comptroller of Public Accounts P.O. Box 149348 Austin, TX 78714-9348 |
| sign here | Date | |

If you have any questions regarding franchise tax, you may contact the Texas Comptroller's field office in your area or call (800) 252-1381 or (512) 463-4600. Instructions for each report year are online at www.window.state.tx.us/taxinfo/taxforms/05-forms.html.

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| | |
|---|---|
| VE/DE | |
| PM Date | |