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Via CMRRR 7013 1710 0001 3068 3685
Teresa G. Bostick
Director of Tax Policy Division
P.O. Box 13528
Austin, Texas 78711-3528

Re: Comments on Proposed Amendments to 34 Texas Administrative Code § 3.588, published in 42 Tex. Reg. 5235

Dear Ms. Bostick:

Martens, Todd, Leonard & Ahlrich submits the comments stated below to the proposed amendments to 34 Texas Administrative Code § 3.588, published in 42 Tex. Reg. 5235. We request that the Comptroller revise the text of its proposed rule for the reasons stated herein. If the Comptroller declines to revise the text of its proposed rule in light of these comments, we request that the Comptroller provide a written explanation as to why it has declined to revise one or more provisions as requested. We further request that the Comptroller transmit these comments for publication in the Texas Register.

We view many of the proposed changes to Comptroller Rule 3.588 to be valid. However, several conflict with governing case law and the plain text of Texas Tax Code § 171.1012(i). We note, as a threshold matter, that the courts have held that Texas Tax Code § 171.1012(i) is unambiguous. *See e.g.*, *Combs v. Newpark Res., Inc.,* 422 S.W.3d 46, n.9 (Tex. App.—Austin 2013, no pet.). When a statute is unambiguous, courts have stated that they will not defer to the Comptroller's interpretation, but instead will follow the statute's plain language. *See Combs v. Roark Amusement*, 422 S.W.3d 632, 635 (Tex. 2013) ("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.' We give such statutes their plain meaning without resort to rules of construction or intrinsic aids."). Accordingly, we believe there is no basis for the Comptroller to propose revisions to a rule that alter the meaning of an unambiguous statute from that stated in final published judicial opinions. *See U.S. v. Home Concrete & Supply, LLC*, No.

11-139, 566 U.S.____ (2012), slip op. at 7-8 (Court declined to grant *Chevron* deference to treasury regulation interpreting a statute's operative language when case law had already interpreted the statute); *See National Cable & Telecomm. Assn. v. Brand X Internet Servs.*, No. 04-277, 545 U.S. 967, 982 (2005) ("A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion.").

a. Project.

The proposed rule's definition of "project" effectively eliminates the words "to a project for" from Texas Tax Code § 171.1012(i). It does so by conflating those words with the phrase that immediately follows it. Subsection (i) states that 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 . . . ." (emphasis added). The proposed rule defines "project" as 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." In doing so, the proposed rule's definition gives no meaning to the words "to a project for" and effectively erases them from the statute.

The words "to a project for" are words of breadth and they transcend the construction work at the site itself. By "site," we mean both construction sites and oilfield sites. The proposed rule's definition of "project" could be read to limit a taxpayer's eligible costs to work performed at a specific site. Controlling case law establishes that a "project" is broader than a singular site.

In *CGG Veritas*, the Court held that seismic data acquisition and processing performed by CGG for its oil and gas exploration and production company customers was labor furnished to a project for the construction of real property. *See Hegar v. CGG Veritas Servs. (U.S.), Inc.*, 2016 Tex. App. LEXIS 2439, at *12 (Tex. App.—Austin Mar. 9, 2016, pet. denied). The "project" for which CGG furnished labor was not a singular site, but rather multiple areas of interest where many wells could potentially be drilled. *See id.* In fact, no sites (*i.e.*, oil wells) even existed at the time CGG performed its work and might not ever exist. Thus, the proposed rule's definition of project might be read to deny companies similar to CGG from claiming the cost of goods sold deduction because they do not perform work at oilfield or construction sites. As a result, the proposed rule would violate the unambiguous statutory scope interpreted by the Third Court of Appeals.

Moreover, the proposed rule's definition of "project" appears to violate the holding of *Gulf Copper & Manufacturing Corp.*, which allowed Gulf Copper to claim the cost of goods sold deduction for costs incurred to repair and overhaul offshore rigs that would be used to drill wells in particular projects (*i.e.*, offshore blocks). *Gulf Copper and Manuf. Corp.*, No. 03-16-00250-

CV, 2017 Tex. App. LEXIS 7631, at *27 (Tex. App.—Austin Aug. 11, 2017, no pet. h.). The court did not require Gulf Copper to be onsite at the project or otherwise engaged in the actual construction—or drilling—of the wells.

As manifested in guiding judicial precedent, the term "project" as used in Texas Tax Code § 171.1012(i) is a term of breadth applicable to a variety of factual circumstances, broader than the site itself. Accordingly, we ask that the Comptroller revise its proposed rule to either: (1) omit the proposed definition of project, or (2) provide a broad definition of project that encompasses furnishing labor or materials to "one or more existing or potential construction, industrial, or oilfield sites, whether provided at the sites themselves or not."

b. Labor.

The proposed rule narrowly defines "labor" as "[l]abor used in the direct prosecution of the project" for purposes of Texas Tax Code § 171.1012(i). It is unclear why the Comptroller proposes to define labor differently under Texas Tax Code § 171.1012(i), particularly when the Third Court of Appeals has said that "there is no reason to believe that 'labor' under section 171.1012(i) means anything different than labor under section 171.1012 generally." *Combs v. Newpark Res., Inc.*, 422 S.W.3d 46, 56. The Third Court has further stated:

> the term "labor" as used in subsection 171.1012(i) has the same meaning as in section 171.1012 generally, which permits taxable entities to deduct "all direct costs of acquiring or producing" goods, including "labor costs."

Hegar v. CGG Veritas Servs. (U.S.), Inc., 2016 Tex. App. LEXIS 2439, at *9-10. Further, currently adopted Comptroller Rule 3.588(d)(1) defines labor costs, and thereby implicitly defines labor to include all direct and indirect labor allocable to the acquisition or production of goods and subject to capitalization under the applicable United States treasury regulations, except for service department-related labor costs.

The existing rule's definition of labor is consistent with judicial precedent. However, the proposed rule's definition is not. The proposed rule's definition of "labor" restricts the broad definition of "labor" iterated by the court in *Newpark*. There, the court defined "labor" as:

> a broad term that encompasses a wide range of activities, including "expenditure of physical or mental effort especially when fatiguing, difficult, or compulsory." None of the surrounding statutory text indicates that labor has a more limited meaning than its common definition. Therefore, we presume that the legislature intended to allow taxable entities to deduct a wide range of labor expenses.

(internal citations omitted). The Court has consistently applied this broad definition of labor in subsequent Texas franchise tax cases. *See Hegar v. CGG Veritas Servs. (U.S.), Inc.*, 2016 Tex. App. LEXIS 2439; *Gulf Copper and Manuf. Corp.*, No. 03-16-00250-CV, 2017 Tex. App. LEXIS 7631, at *11.

Moreover, the proposed rule should recognize that "services" are subsumed within the definition of labor. The broad definition of labor is intended to permit taxable entities to deduct a wide variety of labor expenses, including those associated with activities that might also be described as a "service." *See Hegar v. CGG Veritas Servs. (U.S.), Inc.*, 2016 Tex. App. LEXIS 2439, at *9-10 (citing *Combs v. Newpark Res., Inc.*, 422 S.W.3d at 56); *See Gulf Copper and Manuf. Corp.*, No. 03-16-00250-CV, 2017 Tex. App. LEXIS 7631, at *10-11 (Thus, the Comptroller did not consider whether any of Gulf Copper's costs were for labor and materials furnished to a qualifying project or were associated with activities that might otherwise be viewed as "services," but might nevertheless be eligible for inclusion in the COGS deduction calculation because they were an "essential and direct component of the 'project for construction . . . of real property.'").

Accordingly, we ask that the Comptroller revise the proposed rule's definition of "labor" to comport with this established case law precedent, or alternatively, define the term consistently with Comptroller Rule 3.588(d)(1). We further request that the proposed rule clarify that the term "labor" includes activities that may include "services" for the purposes of Texas Tax Code § 171.1012(i).

c. Materials.

The proposed rule's definition of "materials" under Comptroller Rule 3.588(c)(9)(B)(ii)(I) is confusing within the context of the proposed rule. We propose that the Comptroller revise the definition of "materials" to state, "incorporated items, supplies, equipment leased or rented, or repairs, maintenance, improvement, overhaul, and restoration of, or to, equipment leased or rented to be used at particular projects." *See Gulf Copper and Manuf. Corp.*, No. 03-16-00250-CV, 2017 Tex. App. LEXIS 7631, at *27.

The Comptroller's rationale stated in the preamble to the proposed rules emphasizes the taxpayer's ability to obtain a lien on a construction project, which is a position that the Comptroller has offered on several occasions to the Third Court of Appeals, but has not been accepted. In fact, the Comptroller's preamble even states that *CGG Veritas* did not address the ability of CGG Veritas to obtain a lien. The Comptroller advanced the lien position in both its briefing and oral argument for *Gulf Copper and Manuf. Corp.*, a case decided after *CGG Veritas*, and the Court declined to follow it in its opinion.

d. Owner of Goods.

The current version of Comptroller Rule 3.588(c)(8) adopts verbatim the ownership test set forth in Texas Tax Code 171.1012(i): "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." However, the proposed rule seeks to delete this flexible statutory standard and insert an unnecessary and unexplained presumption that effectively restricts COGS to the legal title holder of goods. Therefore, we request that the Comptroller strike his proposed amendment to Comptroller Rule 3.588(c)(9)(a).

e. Rentals and Leases.

The proposed rule limits the amount of cost of goods sold deduction in a manner that is inconsistent with the express words of the statute. *See* proposed amendments to 34 Tex. Admin. Code § 3.588(c)(9). Texas Tax Code § 171.1012(k-1) qualifies three types of rental or leasing companies to claim the cost of goods sold deduction. They are motor vehicle renting or leasing companies, heavy construction equipment rental or leasing companies, and railcar rolling stock rental or leasing companies.

Once qualified, the rental or leasing companies 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." Texas Tax Code § 171.1012(k-1).

Texas Tax Code § 171.1012(a)(3)(A)(i) defines tangible personal property as "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any manner." Thus, a qualifying rental or leasing company may include in its subtraction all allowable costs incurred in relation to any personal property that it leases or rents.

Accordingly, we request that the Comptroller revise the proposed rule to allow qualifying rental or leasing companies to "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." The statutory text is clear and result is reasonable. For instance, a qualifying heavy equipment rental company ought to be able to deduct the eligible costs incurred in relation to both its light construction equipment as well as the eligible costs incurred in relation to both its heavy construction equipment. Only in doing so, will its tax base reflect its margin. The proposed rule improperly ignores the text of the statute and confines the deduction to the costs incurred to limited types of property, when the statute contains no such limitation.

f. Research and Development.

As part of the rule amendment process, we further request that the Comptroller incorporate his revised policy stated in STAR Document No. 201504069L regarding research and development costs into the COGS rule. *See* STAR Document No. 201504069L (April 23, 2015 memo from Teresa Bostick, Director of Tax Policy, to Denise Stewart, Director of Audit Division – not superseded). There, the Comptroller reviewed Internal Revenue Code authority and determined that "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 the goods it sells."

Accordingly, we believe that adding the following language to 3.588(d)(9) would both be statutorily-consistent and further the Comptroller's goals of reducing uncertainty and avoiding taxpayer controversies:

> 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, regardless of whether the taxable entity is the producer of the good it sells.

g. Effective Date of Proposed Amendments.

In any event, the Comptroller's proposed amendments to the rule ought to be given prospective, rather than retroactive effect. They constitute substantive changes in existing policy and controlling law as decided by the appellate courts. Thus, if the Comptroller rejects our requested revisions and proceeds to adopt his proposed language as stated in the Texas Register, we request, in the alternative, that these subsections state an effective date no earlier than franchise tax reports originally due on or after January 1, 2018. The proposed amendments present a marked change in the COGS framework and the Comptroller should apply them only on a prospective basis. *See Subaru of America v. David McDavid Nissan*, 84 S.W.3d 212, 219-20 (Tex. 2002) (explaining that amendments generally operate prospective and not retroactively, unless the amendment is procedural or remedial and, therefore, does not affect a vested right).

These comments have been timely submitted no later than 30 days from the date of publication of the proposal in the *Texas Register*. We welcome the opportunity to visit with you about our concerns if you so desire.

Very truly yours,

MARTENS, TODD, LEONARD & AHLRICH

By: _____
Jimmy Martens