

201701019H [Tax Type: Franchise] [Document Type: Hearing]

System Disclaimer The Comptroller of Public Accounts maintains the STAR system as a public service. STAR provides access to a variety of document types that may be useful in researching Texas tax law and tax policy. Documents which provide the Comptroller's interpretation of the tax laws are accurate for the time periods and facts presented in the documents. Letters on STAR can be the basis of a detrimental reliance claim only for the taxpayer to whom the letter was directly issued. Documents on STAR that no longer represent current policy may be completely or partially superseded, but there is no assurance that a document on STAR represents current policy even if it has not been marked as superseded.

Tax laws are complex and subject to change. Interpretations of the laws may be affected by administrative hearings, court opinions, attorney general opinions and similar authorities. STAR is a research tool, not a substitute for legal advice. If there is a conflict between the law and the information found on STAR, any decisions will be based on the law.

Texas Comptroller of Public Accounts STAR System

201701019H

SOAH DOCKET NO. 304-16-1436.13

CPA HEARING NO. 112,139

RE: *****

TAXPAYER NO: *****

AUDIT OFFICE: *****

AUDIT PERIOD: January 1, 2009 THROUGH December 31, 2009

SOAH DOCKET NO. 304-16-1437.13

CPA HEARING NO. 112,140

RE: *****

TAXPAYER NO: *****

AUDIT OFFICE: *****

AUDIT PERIOD: January 1, 2008 THROUGH December 31, 2008

SOAH DOCKET NO. 304-16-1435.13

CPA HEARING NO. 112,141

RE: *****

TAXPAYER NO: *****

AUDIT OFFICE: *****

AUDIT PERIOD: January 1, 2010 THROUGH December 31, 2010

Franchise Tax/RFD

BEFORE THE COMPTROLLER
OF PUBLIC ACCOUNTS
OF THE STATE OF TEXAS

GLENN HEGAR
Texas Comptroller of Public Accounts

ISREAL MILLER
Representing Tax Division

Representing Claimant

COMPTROLLER'S DECISION

For a hearing under the APA set by SOAH *on and after* September 1, 2015:

This decision is considered final on February 6, 2017, unless a motion for rehearing is timely filed; this date of finality is calculated based on the Administrative Procedure Act (APA).[1] See attached: "Frequently Asked Questions Related to Motions for Rehearing." The failure to timely file a motion for rehearing may result in adverse legal consequences.

Administrative Law Judge (ALJ) Victor J. Simonds of the State Office of Administrative Hearings (SOAH) issued a Proposal for Decision (PFD) that includes Findings of Fact and Conclusions of Law. SOAH served the PFD on each party and each party was given an opportunity to file exceptions and replies with SOAH in accordance with SOAH's rules of procedure. The ALJ recommended that the Comptroller adopt the PFD as written.

After review and consideration, IT IS ORDERED that the PFD is adopted as changed.[2]

The results from this Decision are Attachments A. The ALJ's letter to the Comptroller is Attachment B. The PFD as changed is Attachment C. Attachments A, B and C are incorporated by reference.

Attachments A reflect credits owed to Claimant.

The credits will be processed after the date the Comptroller's Decision is final. The parties may waive the right to file a motion for rehearing to expedite the processing of the credits. A waiver of rehearing or motion for rehearing may be filed as described above.

SIGNED on this 12th day of January 2017.

GLENN HEGAR
Comptroller of Public Accounts

By: Mike Reissig
Deputy Comptroller

Attachments A, Texas Notifications of Hearing Results
Attachment B, ALJ's letter to the Comptroller
Attachment C, Proposal for Decision as changed
Publication: "Frequently Asked Questions Related to Motions for Rehearing"

Attachment C

SOAH DOCKET NO. 304-16-1435.13

TCPA DOCKET NO. 112,141

SOAH DOCKET NO. 304-16-1436.13

TCPA DOCKET NO. 112,139

SOAH DOCKET NO. 304-16-1437.13

TCPA DOCKET NO. 112,140

TAXPAYER NO. *****

v.

TEXAS COMPTROLLER OF PUBLIC ACCOUNTS

BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS

PROPOSAL FOR DECISION

***** (Claimant) operates a regional grocery store chain that is based in Texas. In 2012, Claimant requested franchise tax refunds based on amended reports for 2008, 2009, and 2010. The Tax Division (Staff) of the Texas Comptroller of Public Accounts (Comptroller) initiated refund-verification audits and, in 2014, Staff approved a portion of each year's request. Claimant contends additional refunds are warranted because Staff erroneously disallowed cost of goods sold (COGS) deductions related to labor costs in the delicatessen, meat market, and pharmacy departments. Staff disagrees. In this Proposal for Decision (PFD), the Administrative Law Judge (ALJ) finds that Claimant's evidence clearly and convincingly demonstrates that the auditor understated certain COGS allocations. The ALJ's specific recommendations are set forth below.

I. PROCEDURAL HISTORY, NOTICE, AND JURISDICTION

Staff referred the contested cases to the State Office of Administrative Hearings on December 7, 2015, and hearings were set that same date. On December 9, 2015, Staff issued Notices of Hearing to Claimant. After concluding the cases shared common issues of fact and law, ALJ Victor John Simonds joined the cases for purposes of issuing a single PFD. On April 27, 2016, the ALJ convened a hearing on the merits. Claimant was represented by ***** and INDIVIDUAL of COMPANY. Staff was represented by Assistant General Counsel Isreal Miller. The contested case record closed at the conclusion of the hearing. 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 provided the testimony of Tianhui Zhan (an auditor assigned to the Comptroller's ***** audit office). Staff offered the following exhibits for each hearing:

1. Notice of Demand Letter;
2. Sixty-Day Letter;
3. Refund Denial Letter;

4. Refund Verification Audit;
5. Refund Verification Plan of Activities; and
6. Refund Claim.

Claimant presented the testimony of INDIVIDUAL B (an industrial engineer employed by Claimant), and INDIVIDUAL C (of COMPANY). Claimant offered the following exhibits:

1. Franchise Tax Base Flowchart;
2. Texas Tax Code § 171.1012;
3. Spreadsheet: Job Categories and COGS Percentages;
4. National Pharmacist Workforce Survey, 2009;
5. Job Description: Deli Manager;
6. Job Description: Deli Clerk;
7. Job Description: Bakery/Deli Manager;
8. Job Description: Assistant Deli Manager;
9. Job Description: Assistant Production Bakery Manager;
10. Job Description: Market Manager;
11. Job Description: Assistant Market Manager;
12. Job Description: Market Clerk;
13. Job Description: Pharmacist;
14. Job Description: Relief Pharmacist;
15. Job Description: Certified Pharmacy Technician;
16. Labor Study: Deli and Meat Market;
17. Revised Labor Study Results Summary;
18. Proposed Franchise Tax Adjustment Summary, 2008;
19. Proposed Franchise Tax Adjustment Summary, 2009;
20. Proposed Franchise Tax Adjustment Summary, 2010;
21. Trial Balance Report and Requested COGS Deduction, 2008;
22. Trial Balance Report and Requested COGS Deduction, 2009;
23. Trial Balance Report and Requested COGS Deduction, 2010; and
24. Compact Disc: Exhibit Nos. 3 and 16 through 23.

Each party's exhibits were admitted into the record without objection.

B. Agreed Adjustments

Staff did not agree to recommend any additional refunds.

C. Material Facts Established by the Evidence

Claimant operates a regional grocery store chain that is based in Texas. In 2012, Claimant requested franchise tax refunds based on amended reports for 2008, 2009, and 2010. Staff initiated refund-verification audits, and the assigned auditor (Ms. Zhan) met with Claimant's representatives to review the job descriptions for grocery store personnel. For each job title, Ms. Zhan determined a percentage of effort that was attributable to acquiring or producing goods. For example, in the pharmacy department, costs attributable to activities such as ordering and shelving medications was deemed to be a deductible direct labor cost. However, Ms. Zhan concluded that costs attributable to filling a customer's prescription were distribution or selling costs that were not deductible. She reached the same conclusion for costs related to taking customer orders in the deli and meat market departments. However, at the hearing on the merits, Ms. Zhan agreed that, in her opinion, a pharmacy department sale had not taken place until the customer actually paid for the medication.[3]

On November 20, 2014, Staff issued the refund-verification audits to Claimant. For each year, Staff approved a refund. For report years 2008 and 2009, Staff allowed additional COGS credits; and for report year 2010, Staff allowed additional COGS credits and adjustments to total revenue for the year. The Staff-approved refunds for the three years totaled \$577,902.69. Claimant requested refund hearings. It contends the percentage of costs attributable to labor costs for the deli, meat market, and pharmacy departments should be increased. According to Claimant, the allowed portion was computed using salary data by position and the resulting overall average allowed (27.16%) was applied to the trial balance amounts. Claimant contends it is entitled to additional COGS deductions because the allowed percentages are understated.

INDIVIDUAL B testified that he has spent hundreds, perhaps thousands, of hours examining labor costs and employee job functions because his job is to compile data that will allow Claimant to create labor standards that can be utilized to forecast labor costs and store employee needs. For example, INDIVIDUAL B stated that managers and supervisors utilize the labor data to set work schedules. Moreover, the data is continuously updated based on actual labor and sales data. He stated that his ultimate task is to reduce non-production labor costs so that hours dedicated to production are maximized. INDIVIDUAL B stated that keeping a store's labor costs down is tied to requiring all department personnel to perform any of the department's tasks. He explained that, generally, the departments created different staffing positions as a way to reward employee service and set pay scales. Claimant's labor study is based on data from its workforce management system and data from observations and interviews from five stores. INDIVIDUAL B testified that the five stores were representative of Claimant's other stores, based on size, departments, and sales. The documentation in the record lists the tasks performed by deli and meat market employees.

INDIVIDUAL B explained that the deli and market departments sell meats and cheeses by weight. The deli also sells prepared food such as sandwiches, fried chicken, pizza, and salads. The market department butchers meat for individual packaging and may grind or otherwise prepare meat that is packaged for sale. The deli and meat market departments do not have cash registers and do not complete sales transactions. However, each product must be weighed and each must include a bar code so that the customer can complete purchase transactions before leaving the store. INDIVIDUAL B explained that

the company's labor study found that production-related activities in the meat market totaled 82.29% of all labor hours. In the deli, the production percentage is 76.98%. However, INDIVIDUAL B conceded that the labor study definition of a production activity is not entirely consistent with the definition utilized for franchise tax COGS purposes. For example, employee tasks related to cleaning production equipment was characterized as a non-production type activity.

Claimant also provided a 2009 National Pharmacist Workforce Survey, which is a market report that is prepared for public and industry use. The study was prepared by the Midwest Pharmacy Workforce Research Consortium, and it determined that pharmacists (including those working at grocery-store pharmacies) spent 70% of their time performing medication dispensing activities and 10% of their time providing customer-care services. The medication dispensing activities included things such as preparing, distributing, and administering medications. INDIVIDUAL B testified that the findings of the national survey were consistent with his observations of pharmacists' activities at Claimant's grocery stores in the refund period at issue.

Claimant also provided formal job descriptions for several job classifications; *e.g.*, deli clerk, bakery/deli manager, assistant deli manager, and market manager. A deli manager's job includes preparing and displaying foods in a manner consistent with Claimant's standards, promoting sales, and overseeing department personnel. Duties include preparing employee work schedules, ordering products, and monitoring employee performance. A deli clerk's job includes preparing hot and cold foods, taking customer orders, slicing cheeses and lunch meats, and preparing catering orders. A bakery/deli manager's job includes preparing bakery goods for sale and overseeing department personnel, much like a deli manager. An assistant manager's duties are similar to a manager's; however, an assistant manager does not set schedules or hire/fire personnel. A pharmacist's job includes filling prescriptions, maintaining inventory, completing necessary paperwork (patient records and logs), and providing customer services. A pharmacy technician's job includes assisting pharmacists to ensure that prescriptions are accurately filled. A technician might also order product and build displays.

INDIVIDUAL C, one of Claimant's tax-consulting representatives, reviewed Claimant's labor study and prepared a revised list of tasks and categorized them as either a production or nonproduction activity based on his understanding of the definition of allowable COGS deductions. The primary distinction between Claimant's study and the tax-revised list relates to cleaning tasks. For example, tasks related to cleaning equipment such as fryers, rotisseries, and meat grinders were defined as nonproduction in Claimant's study. However, INDIVIDUAL C categorized those tasks as allowable production-related tasks for purposes of calculating a COGS deduction. Overall, Claimant contends the percentage of qualifying retail labor should be increased to 41.53%. INDIVIDUAL C utilized Claimant's actual hours that employees spent on tasks at the five representative stores and calculated that 83.67% of the deli department and 87.30% of the market department hours were production-related activities for franchise tax purposes.[4] Claimant applied its requested percentages to the labor cost trial balance values and requests an additional refund of \$330,225.84.[5]

D. ALJ's Analysis and Recommendation

Franchise tax is imposed on each taxable entity that does business in this state or that is chartered or organized in this state. Tex. Tax Code § 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 taxable entity, either the COGS or compensation. *Id.* § 171.101(a)(1). Generally, the burden rests on the taxpayer to show audit error by a preponderance of the evidence. *See* 34 Tex. Admin. Code § 1.40(2) (B). However, the Comptroller has held that a COGS deduction was tantamount to an exemption, which means a taxpayer's evidence must be clear and convincing. *See, e.g.,* Comptroller's Decision

No. 108,066 (2015). Claimant argues that the COGS deduction it seeks is neither an exemption, nor tantamount to an exemption. Therefore, it contends the clear and convincing evidentiary standard does not apply in the instant matter.

In 1998, the Austin Court of Appeals considered a dispute that centered on a taxpayer's claim to a franchise tax deduction of future rental expenses under certain operating leases. *See Texas Utils. Elec. Co. v. Sharp*, 962 S.W.2d 723 (Tex. App.—Austin 1998, pet. denied). As effective in the period 1988 through 1990, the Tax Code required (in relevant part) that corporations pay a tax on net taxable capital, and the determination of net taxable capital required the application of a sequence of definitions. *See* Tex. Tax Code § 171.001, .002. For example, net assets included corporate surpluses, and net assets were total corporate assets minus total debts. Tex. Tax Code § 171.109. “In other words, ‘debts’ ~~([were])~~ deductible from a corporation's taxable surplus under the Tax Code.” *Texas Utils. Elec. Co.*, 962 S.W.2d at 725. The case turned on whether the future rentals were deductible as debts, and the court held that: “[W]e construe tax exemptions—and provisions tantamount to tax exemptions—strictly against the taxpayer . . . We believe the provision at issue . . . in this case, one authorizing a deduction, is tantamount to an exemption.” *Id.* at 726. Instead of deducting debts from corporate assets, the Tax Code currently allows certain taxable entities to deduct, for example, allowable COGS from total revenue. The salient point is that the function of the deduction has not changed. Therefore, the ALJ recommends that Claimant's burden of proof argument be rejected. With respect to the COGS disputes presented by the contested case, Claimant must demonstrate with clear and convincing evidence that the costs it claims as deductions fit within the statutory definition of a COGS.

A taxable entity that elects to subtract COGS for the purpose of computing its taxable margin is entitled to include all direct costs of acquiring or producing goods. Tex. Tax Code § 171.1012. A taxable entity may include in its COGS 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. 34 Tex. Admin. Code § 3.588(d)(1). A taxable entity may also subtract service costs that it can demonstrate are reasonably allocable to the acquisition or production of goods. *Id.* § 3.588(f). Deductible service costs are 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. *Id.* § 3.588(b)(9). 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. *Id.* The service costs amount subtracted may not exceed 4.0% of total indirect and administrative overhead costs. *Id.* § 3.588(f). However, some costs are excluded and cannot be deducted. The COGS does not include, for example, selling costs (including employee expenses related to sales) and distribution costs (including outbound transportation costs). *Id.* § 3.588(g)(2), (3).

Generally, Claimant contends the auditor under-allocated its allowable direct COGS. At the conclusion of the hearing, Staff conceded that certain adjustments were likely warranted. However, Staff points out, for example, that it is counterintuitive to assume that Claimant would assign management-level employees to the same tasks as it does to non-management level employees.

Claimant's evidence is thorough, well organized, and persuasive. The ALJ also recognizes the obvious merit to Staff's managerial-related arguments. But, as the parties are aware, costs related to supervising

production labor are an allowable deduction. *See* State Tax Automated Research (STAR) System Document No. 201010997L (October 1, 2010). Therefore, the relevant question is not whether Claimant's managers performed the exact tasks as clerks. The salient issue is: does Claimant's evidence demonstrate that the auditor's allocations are incorrect. For example, does Claimant's evidence demonstrate that assistant bakery/deli managers spent more than 10% of their time performing or supervising production tasks? If so, what allocation does Claimant's evidence support?

The auditor stated that, at least with respect to non-managerial positions, the general basis for her allocation was a review of the position's job description and the statutory provisions that selling and distribution costs should be excluded from a COGS deduction. The Comptroller's interpretation of the Tax Code is that wholesalers' and retailers' COGS deductions can include costs that are incurred from the point of acquisition of the goods (inventory) through the point of putting the goods on display for sale. *See, e.g.,* Comptroller's Decision No. 106,998 (2013). Costs incurred after the point the goods are displayed are considered selling costs and are not allowed as a COGS. *Id.* For example, compensation that is paid to employees who stock grocery store shelves can be included in a COGS deduction. *See, e.g., Comptroller's Decision Nos. 107,281 & 107,282 (2013); see also,* Tax Policy News, January 2011, STAR Document No. 201101084L. However, compensation paid to cashiers and baggers cannot be included. *Id.*

Claimant's evidence demonstrates that no sales transactions were being completed by personnel within the deli and market departments. However, Claimant's job description evidence demonstrates that a deli clerk's tasks include taking customer orders. The auditor determined that those tasks were related to selling goods and sought to exclude costs related to those tasks. Claimant's evidence lists over 40 deli-related tasks (*e.g.,* ordering and packaging inventory, creating party trays, cleaning production-related equipment). The auditor allocated only 25% of the costs related to deli clerks to production-related activities. Claimant contends the correct production-related allocation is 83.67%. The ALJ finds that Claimant's evidence clearly and convincingly demonstrates that the auditor's allocation is too low. Moreover, Claimant's allocation, 83.67%, is sufficiently supported by the evidence. The same is true of the various assistant managerial deli positions. The job descriptions for an assistant deli manager and an assistant production bakery manager do include tasks related to oversight of deli operations; however, those tasks are related to supervising production. As has been explained, costs related to supervising production are allowable. However, the ALJ does agree with Staff's arguments that the allocation for the deli and market managers should not be the same as the other positions. Costs related to hiring and firing personnel, scheduling, compiling data related to sales, profit, and shrink are not deductible as direct costs. Claimant stated in argument that those tasks were already considered in the various labor study production calculations, but the ALJ finds the evidence to be less than clear and convincing on that point. The ALJ finds that Claimant's evidence does demonstrate that the auditor's 25% allocations for costs related to deli and market managers are incorrect; however, the evidence does not adequately support Claimant's allocation either. Based on INDIVIDUAL B's testimony, the labor study, and the job descriptions, the ALJ finds that 70% of the deli and market manager tasks are production related.

With respect to disputed pharmacy-related cost allocations, the auditor set the production percentages at 20% to 25%.^[6] Claimant contends those allocations should be raised to 70%. The policy basis for the auditor's initial allocation is that costs related to putting medications on the shelves were allowable but costs related to filling a prescription were selling costs that are not allowed. Staff did not provide (and the ALJ could not locate) any policy statement or Comptroller's Decision that specifically addresses allowable COGS deductions for pharmacies; however, even the auditor admitted that, from her point of view, a purchase for prescription medication was not completed until the customer actually picked up and paid for the medication. In fact, INDIVIDUAL B stated that it is not uncommon for a pharmacist to

fill a prescription, only to later have to return the medication to stock because the consumer never came to pick up the product.

Transactions completed within the pharmacy department are different from normal retail transactions. For example, when a consumer purchases make-up or a blouse, he or she will simply select the desired items from the shelf or rack, proceed to the cashier, and pay for the selected items. A consumer cannot simply select several Xanax pills off the pharmacy shelf. He or she must have a doctor-issued prescription for the medication, and the pills must be dispensed by a licensed pharmacist. Just as the costs related to preparing and packaging cheese or meat inventory are deductible, the costs related to filling a prescription are deductible as well. In the pharmacy, labor costs related to ringing-up and bagging the transaction should be excluded. The same is true of costs related to pharmacist counseling. But, unlike the generic retail transaction, costs related to pharmacy department production extend through the point that the prescription is finally filled because, unlike the general retail transaction, a licensed employee must dispense the items to be purchased. With respect to the pharmacy department, Claimant's evidence consists of a 2009 national survey and the testimony of Mr. Freeman. The ALJ finds that Claimant's evidence clearly and convincingly demonstrates that the auditor's allocation is understated. Claimant's allocation, 70.00%, is sufficiently supported by the evidence. The ALJ's recommendations are as follows:

<u>Position</u>	<u>Dept.</u>	<u>Allowed</u>	<u>Requested</u>	<u>Recommended</u>
Asst. Bakery/Deli Mgr	Deli	10.00%	83.67%	83.67%
Asst. Deli Mgr.	Deli	25.00%	83.67%	83.67%
Certified Bakery/Deli Mgr	Deli	25.00%	83.67%	70.00%
Certified Deli Mgr.	Deli	25.00%	83.67%	70.00%
Deli Clerk	Deli	25.00%	83.67%	83.67%
Deli Cook	Deli	25.00%	83.67%	83.67%
Deli Mgr.	Deli	25.00%	83.67%	70.00%
Sous Chef	Market	85.00%	83.67%	83.67%
Asst. Market Mgr.	Market	25.00%	87.30%	87.30%
Certified Market Mgr.	Market	25.00%	87.30%	70.00%
Fresh Market Mgr.	Market	25.00%	87.30%	70.00%
Market Clerk	Market	25.00%	87.30%	87.30%
Market Partner	Market	10.00%	87.30%	87.30%
Market Specialist	Market	10.00%	87.30%	87.30%
Meat Cutter	Market	90.00%	87.30%	87.30%

<u>Position</u>	<u>Dept.</u>	<u>Allowed</u>	<u>Requested</u>	<u>Recommended</u>
Meat Wrapper	Market	90.00%	87.30%	87.30%
Service Meat Mgr.	Market	10.00%	87.30%	70.00%
Certified Pharmacy Tech	Pharm	25.00%	70.00%	70.00%
Hourly Pharmacist	Pharm	20.00%	70.00%	70.00%
Pharmacy Tech In-Training	Pharm	25.00%	70.00%	70.00%
Pharmacy Tech	Pharm	25.00%	70.00%	70.00%
Relief Pharmacist	Pharm	20.00%	70.00%	70.00%
Salary Pharmacist	Pharm	20.00%	70.00%	70.00%

III. FINDINGS OF FACT

1. ***** (Claimant) operates a regional grocery store chain that is based in Texas.
2. In 2012, Claimant requested franchise tax refunds based on amended reports for 2008, 2009, and 2010.
3. The Tax Division (Staff) of the Texas Comptroller of Public Accounts (Comptroller) initiated refund-verification audits, and the assigned auditor (Tianhui Zhan) met with Claimant's representatives to review the job descriptions for grocery store personnel.
4. For each job title, Ms. Zhan determined a percentage of effort that was attributable to acquiring or producing goods.
5. A pharmacy department sale does not take place until the customer actually pays for the medication.
6. On November 20, 2014, Staff issued the refund-verification audits to Claimant. For each year, Staff approved a refund. For report years 2008 and 2009, Staff allowed additional cost of goods sold (COGS) credits; and for report year 2010, Staff allowed additional COGS credits and adjustments to total revenue for the year. The Staff-approved refunds for the three years total \$577,902.69.
7. Claimant requested refund hearings.
8. On December 7, 2015, Staff referred the contested cases to the State Office of Administrative Hearings (SOAH), and hearings were set that same date.
9. On December 9, 2015, Staff issued Notices of Hearing to Claimant. The notices 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.
10. After concluding the cases shared common issues of fact and law, the Administrative Law Judge (ALJ) joined the cases for purposes of issuing a single Proposal for Decision.

11. On April 27, 2016, the ALJ convened a hearing on the merits.
12. The contested case record closed at the conclusion of the hearing.
13. INDIVIDUAL B has spent hundreds of hours examining labor costs and employee job functions because his job is to compile data that will allow Claimant to create labor standards that can be utilized to forecast labor costs and store employee needs. For example, managers and supervisors utilize the labor data to set work schedules. Moreover, the data is continuously updated based on actual labor and sales data. His ultimate task is to reduce non-production labor costs so that hours dedicated to production are maximized.
14. Part of keeping labor costs down involves requiring all department personnel to perform any of the department's tasks. Generally, Claimant's departments create different staffing positions as a way to reward employee service and set pay scales.
15. Claimant's labor study is based on data from its workforce management system and consists of observational and interview based data from five stores. The documentation in the record lists the tasks performed by deli and meat market employees.
16. The five stores evaluated in the labor study were representative of Claimant's other stores, based on size, departments, and sales.
17. Claimant's deli and market departments sell meats and cheeses by weight. The deli also sells prepared food such as sandwiches, fried chicken, pizza, and salads. The market department butchers meat for individual packaging and may grind or otherwise prepare meat that is packaged for sale. The deli and meat market departments do not have cash registers and do not complete sales transactions. However, each product must be weighed and each must include a bar code so that the customer can complete purchase transactions before leaving the store.
18. Claimant's labor study demonstrates that production-related activities in the meat market department total 82.29% of all labor hours. In the deli, the production percentage is 76.98%.
19. The labor study definition of a production activity is not entirely consistent with the definition utilized for franchise tax COGS purposes. For example, employee tasks related to cleaning production equipment was characterized as a non-production type activity in the labor study.
20. Claimant utilized the franchise-tax adjusted labor study to examine the actual hours that employees spent on tasks at the five representative stores. Claimant calculated that 83.67% of the deli department and 87.30% of the market department hours were production-related activities.
21. The 2009 National Pharmacist Workforce Survey is a market report prepared for public and industry use. The study was prepared by the Midwest Pharmacy Workforce Research Consortium, and it determined that pharmacists, including those working at grocery-store pharmacies, spent 70% of their time on ~~to~~ medication dispensing activities and 10% of their time providing customer-care services. The medication dispensing activities included things such as preparing, distributing, and administering medications.
22. The findings of the national survey are consistent with pharmacists' activities at Claimant's grocery stores in the refund period.
23. A deli manager's job includes preparing and displaying foods in a manner consistent with Claimant's standards, promoting sales, and overseeing department personnel. Duties include preparing employee

work schedules, ordering products, and monitoring employee performance.

24. A deli clerk's job includes preparing hot and cold foods, taking customer orders, slicing cheeses and lunch meats, and preparing catering orders.

25. A bakery/deli manager's job includes preparing bakery goods for sale and overseeing department personnel, much like a deli manager.

26. An assistant manager's duties are similar to a manager's; however, an assistant manager does not set schedules or hire and fire personnel.

27. A pharmacist's job includes filling prescriptions, maintaining inventory, completing necessary paperwork (patient records and logs), and providing customer services.

28. A pharmacy technician's job includes assisting pharmacists to ensure that prescriptions are accurately filled. A technician might also order product and build displays.

29. Claimant's evidence lists over 40 deli-related tasks (*e.g.*, ordering and packaging inventory, creating party trays, cleaning production-related equipment). The evidence lists similar tasks that are related to the meat market.

30. No sales were being completed by personnel within the deli and market departments.

31. Transactions completed within the pharmacy department are different from normal retail transactions. For example, a consumer cannot simply select several Xanax pills off the pharmacy shelf. He or she must have a doctor-issued prescription for the medication, and the pills must be dispensed by a licensed pharmacist.

32. Claimant's evidence clearly and convincingly supports the following allocations:

<u>Position</u>	<u>Dept.</u>	<u>Production Allocation</u>
Asst. Bakery/Deli Mgr	Deli	83.67%
Asst. Deli Mgr.	Deli	83.67%
Certified Bakery/Deli Mgr	Deli	83.67%
Certified Deli Mgr.	Deli	83.67%
Deli Clerk	Deli	83.67%
Deli Cook	Deli	83.67%
Deli Mgr.	Deli	83.67%
Sous Chef	Market	83.67%
Asst. Market Mgr.	Market	87.30%
Certified Market Mgr.	Market	87.30%

<u>Position</u>	<u>Dept.</u>	<u>Production Allocation</u>
Fresh Market Mgr.	Market	87.30%
Market Clerk	Market	87.30%
Market Partner	Market	87.30%
Market Specialist	Market	87.30%
Meat Cutter	Market	87.30%
Meat Wrapper	Market	87.30%
Service Meat Mgr.	Market	87.30%
Certified Pharmacy Tech	Pharm	70.00%
Hourly Pharmacist	Pharm	70.00%
Pharmacy Tech In-Training	Pharm	70.00%
Pharmacy Tech	Pharm	70.00%
Relief Pharmacist	Pharm	70.00%
Salary Pharmacist	Pharm	70.00%

IV. CONCLUSIONS OF LAW

1. The Comptroller has jurisdiction over these matters. *See* Tex. Tax Code ch. 111.
2. SOAH has jurisdiction over matters related to the hearings, including the authority to issue a proposal for decision with findings of fact and conclusions of law. *See* Tex. Gov't Code ch. 2003.
3. Staff provided proper and timely notices of the hearings. *See* Tex. Gov't Code ch. 2001.
4. Franchise tax is imposed on each taxable entity that does business in this state or that is chartered or organized in this state. Tex. Tax Code § 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 taxable entity, either the COGS or compensation. Tex. Tax Code § 171.101(a)(1).
6. Generally, the burden rests on the taxpayer to show audit error by a preponderance of the evidence. *See* 34 Tex. Admin. Code § 1.40(2)(B).
7. A COGS deduction is tantamount to an exemption, which means a taxpayer's evidence must be clear and convincing. *See, e.g.,* Comptroller's Decision No. 108,066 (2015). *See also Texas Utils. Elec. Co. v. Sharp*, 962 S.W.2d 723 (Tex. App.—Austin 1998, pet. denied).
8. A taxable entity that elects to subtract COGS for the purpose of computing its taxable margin is entitled to include all direct costs of acquiring or producing goods. Tex. Tax Code § 171.1012.

9. A taxable entity may include in its COGS 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. 34 Tex. Admin. Code § 3.588(d)(1).
10. A taxable entity may also subtract service costs that it can demonstrate are reasonably allocable to the acquisition or production of goods. 34 Tex. Admin. Code § 3.588(f).
11. Deductible service costs are 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. 34 Tex. Admin. Code § 3.588(b)(9).
12. 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. The service costs amount subtracted may not exceed 4.0% of total indirect and administrative overhead costs. 34 Tex. Admin. Code § 3.588(b)(9), (f).
13. The COGS deduction does not include, for example, selling costs (including employee expenses related to sales) and distribution costs (including outbound transportation costs). 34 Tex. Admin. Code § 3.588(g)(2), (3).
14. Costs related to supervising production labor are an allowable deduction. *See* State Tax Automated Research (STAR) System Document No. 201010997L (October 1, 2010).
15. Generally, a wholesalers' and retailers' COGS deduction can include costs that are incurred from the point of acquisition of the goods (inventory) through the point of putting the goods on display for sale. Costs incurred once the goods are displayed are considered selling costs and are not allowed as a COGS. For example, compensation that is paid to employees who stock grocery store shelves can be included in a COGS deduction. However, compensation paid to cashiers and baggers cannot be included. *See, e.g.,* Comptroller's Decision Nos. 106,998 (2013) and 107,281 & 107,282 (2013); Tax Policy News, January 2011, STAR Document No. 201101084L.
16. Claimant's evidence clearly and convincingly demonstrates that the certain auditor production allocations are too low.
17. Claimant's evidence does not support its requested production allocations with respect to deli and market department managers.
18. Costs related to bagging and ringing-up a retail transaction are not deductible. *See, e.g.,* Comptroller's Decision Nos. 107,281 & 107,282 (2013); STAR Document No. 201101084L.
19. Costs related to pharmacist-customer medication counseling are not deductible.
20. The schedules supporting the tax adjustment summaries related to Claimant's franchise tax refund-verification audits for report years 2008, 2009, and 2010 should be amended to base Claimant's allowable COGS deductions on its trial balance reports and the allocations detailed in Finding of Fact No. 32. The calculated additional credit amounts should be credited or refunded to Claimant.

SIGNED May 9, 2016.

**VICTOR JOHN SIMONDS
ADMINISTRATIVE LAW JUDGE
STATE OFFICE OF ADMINISTRATIVE HEARINGS**

ENDNOTES:

[1] The date calculated is 25 days after this decision is signed. *See* APA, Tex. Gov't Code § 2001.146(a); S.B. 1267, Acts 2015, 84th Leg., Sec. 7 and 9 (for a hearing set by SOAH on and after September 1, 2015).

[2] *See* Tex. Gov't Code § 2003.101(e) and (f).

[3] Ms. Zhan Testimony at 36:45.

[4] Claimant's Exhibit No. 24.

[5] Claimant's Exhibit Nos. 21 through 24.

[6] The auditor set production percentages for Pharmacy Operation Specialists and Pharmacy Managers at 0% and 15%, respectively. However, those allocations are not disputed.

ACCESSION NUMBER: [201701019H](#)
SUPERSEDED: N
DOCUMENT TYPE: H
DATE: 01/12/2017
TAX TYPE: FRANCHISE