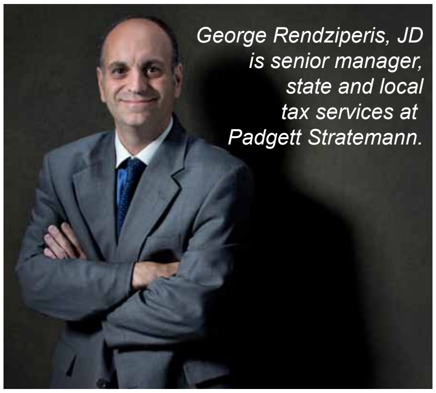
Construction Industry Successful in Negotiations with Comptroller



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Effective June 5, 2013, the Texas Comptroller has revised Margin Tax Rule §3.588 concerning the Cost of Goods Sold (COGS) deduction. Under the revised rule, taxpayers may include as COGS both direct labor costs and those indirect labor costs, other than service costs, that are subject to capitalization under Internal Revenue Code (IRC) §263A and its regulations.

This change has taken over a year of negotiations and meetings between the Construction Industry and the Comptroller. The Construction Industry did not feel that the Comptroller was interpreting Texas Code §171.1012 correctly resulting in certain costs (supervisory costs) being disallowed by the Comptroller as a valid Texas COGS deduction.

The Texas Construction Association and other associations and members of the Construction Industry scheduled meetings with the Comptroller to discuss its policy and educate the Comptroller on the construction industry's practices of allocating costs incurred to its various jobs. As a result of the dialog with the Comptroller, the Comptroller put a hold on all audits of construction companies in order to understand these industry practices.

Under the Comptroller's former policy, it interpreted Texas Code §171.1012 that the only allowable direct labor costs were employees directly working on the job site (i.e., putting hammer to nail). This interpretation resulted in the Comptroller disallowing various expenses as Texas COGS.

Under the revised rule, a taxpayer may include as COGS labor costs, other than service costs, that are properly allocable to the acquisition or production of goods and are of the type of costs subject to IRS Regulation §1.460-5 as direct labor costs, indirect labor costs, employee benefit expenses, or pension and other related costs, regardless of whether the taxpayer actually capitalizes these costs for federal income tax purposes.

Labor costs include W-2 wages, IRS form 1099 wages, temporary labor expenses, payroll taxes, pension contributions, and employee benefits expenses including per diem reimbursements for travel expenses. Labor costs that do not meet the definition above may be deductible under another provision of the rule.

The revised COGS rule added a definition of "service costs." Service costs may be taken as indirect COGS subject to the 4% limitation. Service costs are indirect labor costs and administrative overhead costs that can be identified with a service department or function, or that directly benefit or are incurred by reason of a service department function. 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 revision of Margin Tax Rule section 3.588 is a change of policy by the Comptroller as a result of the hard work, effort and dedication of the Texas Construction Association and other associations and members of the construction industry. The revised rule should create consistency among taxpayers and the Comptroller regarding the application to labor costs.

In other Texas tax news, the governor has signed House Bills 500 & 2766. These have direct implications for construction companies and are discussed below.★

Legislature Makes Major Changes to Franchise Tax Law

Construction Industry Fares Well

With strong encouragement from various business interests, the Texas legislature passed House Bill 500 during the 83rd Regular Legislative Session. The bill retained several of the House's industry specific fixes and included the Senate's temporary across the board tax cut of 5% that is phased in over two years (2.5% first year and 5% second year), revenue permitting. Major details that affect construction companies are:

- Effective January 1, 2014
- Temporary reduction in the 1% and .5% tax rates: 1st year a 2.5% reduction and 2nd year 5% reduction subject to the Comptroller certifying that revenue is available to allow for the 5% reduction.
- Substitutes the current $1 million small business exemption for a revised taxable margin calculation based on the lessor of:
    - 70% of the taxable entity's total revenue, or
    - an amount equal to the taxable entity's total revenue minus $1 million, or
    - an amount computed by subtracting from total revenue the greater of $1 million, COGS or Compensation.
- Provides that taxable entities that are primarily engaged in transporting aggregates or barite can exclude from total revenue subcontracting payments made to independent contractors for delivery services.
- Provides that relocation costs by new entities to Texas may deduct the relocation costs in the first filed franchise tax return.
- Creates a new tax credit for certified rehabilitation of certified historic structures only for returns filed for report year 2014.
- Provides that subcontractor payments related to real property improvements and remediation projects can be deducted from total revenue. (HB 2766) ★