



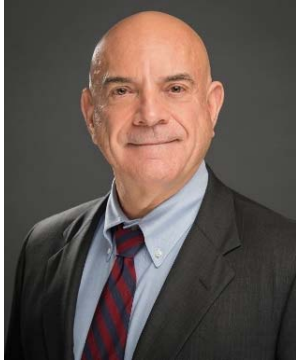
Texas Tax New Developments

2018

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Introduction

This paper discusses a variety of important Texas tax developments occurring during 2017-2018, including four franchise tax cases pending at the Texas Supreme Court, the Comptroller's new Cost of Goods Sold Rule and the most important US Supreme Court sales tax case arising in the past several decades.

I. Franchise Tax

A. Rate

Background. A taxable entity primarily engaged in retail or wholesale trade qualifies for the reduced Texas franchise tax rate. A taxable entity is primarily engaged in a retail or wholesale trade only if:

- (1) the 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 and wholesale trades;
- (2) less than 50% of the total revenue from activities in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs; and
- (3) the taxable entity does not provide retail or wholesale utilities, including telecommunications services, electricity, or gas.¹

The second prong, the “producers test,” asks if more than half of the entity’s retail/wholesale revenues come from sales of items the entity has purchased from third parties or from items the entity or its affiliate has produced. If more come from resale of third-party-produced items, the entity passes the test and may claim the lower rate. If more come from items the entity or its affiliates have produced, the entity is treated as a producer rather than a retailer/wholesaler and may not claim the lower rate.

The Comptroller considers a taxable entity to be the producer of a given item if it performs any part of the manufacturing or assembly of the product, produces its component part, or makes modifications to an acquired product that increase the value of the product by more than 10%.

Prepaid Calling Cards

Prior to January 1, 2018, retailers or wholesalers engaged in the sale of prepaid phone calling cards were often disqualified for the lower franchise tax rate for retailers or wholesalers because providing prepaid phone calling cards was considered a telecommunications service. An entity who provides “retail or wholesale utilities, including telecommunications services, electricity, or gas” cannot qualify for the reduced rate.²

¹ Tex. Tax Code § 171.002 (c); 34 Tex. Admin. Code § 3.584(d)(3).

² Tex. Tax Code § 171.002(c)(3).

Effective January 1, 2018, a legislative change in Texas Tax Code § 171.002 clarifies that “the provision of telecommunications services does not include selling telephone prepaid calling cards.”³ This taxpayer-friendly change in the statute will allow a variety of taxpayers to now qualify for the reduced franchise tax rate.

Prescription Eyeglass Distributor

The Comptroller issued a hearing decision holding that a prescription eyeglass distributor did not qualify for the reduced Texas franchise tax rate because the distributor’s processing activities related to lenses primarily constituted production or manufacturing rather than retailing.⁴

The Comptroller determined that the distributor’s processing (grinding and polishing) of lenses at its in-store and regional laboratories resulted in a different product from the blank lenses that it purchased, thereby making the distributor a “manufacturer” of eyeglasses. The Comptroller further determined that the manufactured lenses were incorporated into 100% of the eyeglasses the distributor sold, and that more than 50% of the distributor’s total revenue from its activities in retail came from the sale of its manufactured lenses, thereby disqualifying it from the reduced rate.

Laundry, Dry Cleaning and Uniform Sales and Rental

The Comptroller issued a hearing decision holding that a laundry and dry-cleaning company and its affiliated entities that also rented and sold uniforms and other related items were not entitled to use the reduced Texas franchise tax rate. The taxpayer asserted that it derived more than 50% of its revenue from retail sales. However, the Comptroller determined that the taxpayer failed to provide sufficient evidence that it was eligible to use the reduced rate because it “[did] not provide retail or wholesale utilities, [did] not produce the products that it sold, and [did] not obtain the products it [sold]” from affiliated entities.

Retail Item Sales Price Increased by Repairs

Where an entity has purchased items produced by third parties and then repairs the items before reselling them, the Comptroller uses the increase in the sales price of the items, not the cost of the repairs, to determine the increase in value of the items. Where the repairs increase the sales price by more than 10%, the entity is treated as a producer of those items, not a reseller/wholesaler, and is not eligible for the reduced rate. In a recent hearing decision, the Comptroller considered whether a taxpayer was a producer of pallets that it purchased, repaired, and resold at a higher price. The taxpayer argued that a minimal amount of labor and materials went into the repairs, such as nails and 1 to 4 twelve-cent replacement boards per pallet, and that those costs should be used to determine the increased value of the pallets. However, because the resale price was over 10% higher

³ H.B. 2126, Act of May 29, 2017, 85th Leg., R.S. (to be codified at Tex. Tax Code § 171.002(c-2) (eff. Jan. 1, 2018)).

⁴ Comptroller Hearing No. 108,321 (April 2018).

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