



Volume 19 Number 2 June 2012

## Texas Comptroller Amends Position on Amended Margin Tax Return Deductions

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In June 2012, the Texas Comptroller revised its position regarding the election to take the cost of goods sold (“COGS”) or compensation deduction when filing an amended Texas margin tax return.<sup>1</sup> Under the revised position, taxpayers may now amend reports to change the original election, or make an election, to calculate their taxable margin using either the COGS or compensation deduction.

### Calculation of Taxable Texas Margin

A business’s tax liability under the margin tax is calculated on the basis of the entity’s “taxable margin.”<sup>2</sup> An entity’s taxable margin is equal to the lesser of 70 percent of total revenue OR total revenue less COGS OR total revenue less compensation.<sup>3</sup> The taxable margin is multiplied by the entity’s Texas apportionment factor (Texas sales or receipts divided by sales or receipts from everywhere) and then by the appropriate tax rate: 1 percent for most taxable entities, 0.5 percent for taxable entities primarily engaged in retail or wholesale trade.<sup>4</sup> An election to deduct either COGS or compensation from total revenue, as opposed to using the 70 percent of revenue method, is made on the entity’s annual report.<sup>5</sup> The election is effective only for that annual report, and Section 171.101(d) of the Texas Tax Code provides that the entity “shall notify the comptroller of its election not later than the due date of the annual report.”

### Prior Comptroller Position

Since the Texas margin tax became effective, the Comptroller has taken the position that if an election to deduct COGS or compensation is not made by the return due date, the 70 percent method will apply.<sup>6</sup> On November 7, 2008, the Comptroller proposed amendments to Rule 3.584,

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<sup>1</sup> Texas Comptroller of Public Accounts, Important Information Concerning Cost of Goods Sold (COGS) and Compensation Deduction Elections, *available at* [http://www.window.state.tx.us/taxinfo/franchise/cog\\_compensation.html](http://www.window.state.tx.us/taxinfo/franchise/cog_compensation.html) (last visited July 5, 2012).

<sup>2</sup> Texas Tax Code § 171.002.

<sup>3</sup> *Id.* § 171.101(a)(1).

<sup>4</sup> *Id.* § 171.002(a), (b).

<sup>5</sup> *Id.* § 171.101(d).

<sup>6</sup> *See* Comptroller Rule 3.584(d)(1) (as adopted Dec. 28, 2007).

clarifying its position. These amendments, which were adopted as final on December 26, 2008, provide that an election to deduct COGS or compensation must be made by the later of the return due date or the time the return is filed.<sup>7</sup> If no election is made, the 70 percent method is used.<sup>8</sup> The amended Rule also provides that an entity may not change its election to COGS or compensation on an amended return filed after the due date, but it may change from COGS or compensation to the 70 percent method.<sup>9</sup>

### **Challenges to the Comptroller's Prior Position**

In Comptroller Hearing No. 103,083 (July 28, 2010), a taxpayer filed an amended margin tax return for 2008 in which it sought to change the method it used to calculate its taxable margin from the 70 percent of revenue method to COGS. The Comptroller denied the refund, citing Rule 3.584, which the Comptroller claimed precludes a taxable entity from amending its report to change its election to the COGS or compensation deduction after the report's due date. The taxpayer requested a refund hearing on the grounds that the original report had been prepared using the best information available and that a later review of its business and a redesign of its accounting system produced an accurate COGS calculation.

The decision of the administrative law judge ("ALJ") turned on the construction of Texas Tax Code § 171.101(a) and (d) and Rule 3.584(f). The ALJ agreed with the Comptroller and affirmed the denial of the refund claim. The ALJ stated that the 70 percent of total revenue method of computing margin is not an election, but rather operates as a base line or default for computing margin, and for this reason, it is not inconsistent for the Comptroller to allow amendments to change from COGS or compensation to the 70 percent method while prohibiting the reverse change. The ALJ also found that the Comptroller's position was supported by the legislative history of Texas Tax Code § 171.101(d).

Several other taxpayers have lost on similar issues at the administrative-hearing level.<sup>10</sup> At least two taxpayers had filed suits in district court on the issue,<sup>11</sup> but these cases had not been tried at the time of the Comptroller's change in position.

### **The Comptroller's Revised Position**

In June 2012, the Comptroller issued a notice that it had reconsidered its position on electing to deduct COGS or compensation on an amended return.<sup>12</sup> The notice does not give the

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<sup>7</sup> Comptroller Rule 3.584(d)(1).

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> See Comptroller Hearing No. 104,076 (Feb. 2011) (taxpayer not entitled to change from 70 percent deduction to COGS on amended return); Comptroller Hearing No. 103,807 (Nov. 2010) (taxpayer not entitled to change from 70 percent deduction to compensation on amended return); Comptroller Hearing No. 103,450 (Aug. 2010) (taxpayer not entitled to change from E-Z computation to COGS on amended return).

<sup>11</sup> See *Basic Energy Servs., Inc. v. Combs*, Cause No. D-1-GN-11-003101 (filed Oct. 10, 2011, Travis Co. Dist. Ct.); *Bigham Bros. Inc. v. Combs*, Cause No. D-1-GN-11-002206 (filed July 21, 2011, Travis Co. Dist. Ct.).

<sup>12</sup> Texas Comptroller of Public Accounts, Important Information Concerning Cost of Goods Sold (COGS) and Compensation Deduction Elections, *supra* n. 1.

Comptroller's reasoning. The Comptroller may have determined that the additional tax revenue was not worth the time and expense of litigating the issue, or it may have reevaluated the strength of its position at the trial-court level. As a result of the change in position, taxpayers may now file amended reports electing to use the COGS or compensation deduction. Taxpayers that elected to use the E-Z computation report may also amend to the long-form report, electing either the COGS or compensation deduction. Amended reports may be filed for any period for which the statute of limitations is still open (generally four years). The Comptroller will also amend Rule 3.584 to be consistent with its new position.



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