

Texas Comptroller Amends Franchise Tax Rules for Retail or Wholesale Trade

Overview

On December 2, 2016, the Texas Comptroller of Public Accounts (Comptroller) adopted amendments to Tex. Admin. Code § 3.584 (Rule 3.584), including changes to the application of the reduced franchise tax rate available for certain entities primarily engaged in retail or wholesale trade.¹ As discussed below, elements of the originally proposed amendments affecting the Self-Production Test were not formally adopted. Nonetheless, the Comptroller has indicated the policy surrounding the proposed amendments to the Self-Production Test² continues to apply and that additional amendments will be proposed in the future related to Rule 3.584.

In this Tax Alert, we summarize certain provisions of the proposed amendments along with the amended regulation as adopted.

Originally Proposed Amendments to Self-Production Test

On May 20, 2016, the Comptroller issued proposed amendments to Rule 3.584³ for public comment, including the addition of language to the definition of "primarily engaged in retail or wholesale trade" which was intended to memorialize the Comptroller's guidance as reflected in Accession No. 201508350L.⁴ Prior to amendment, the regulation classified entities as "primarily engaged in retail or wholesale trade" only if: (a) the total revenue from its activities in retail or wholesale trade is greater than total revenue from its other activities; (b) less than 50% of the total revenue from activities in retail or wholesale trade comes from the sale of products the entity produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs (commonly referred to as the "Self-Production Test"); and (c) the taxable entity does not provide retail or wholesale utilities.⁵

The proposed amendment would have added language clarifying the Self-Production Test. Rule 3.584(2)(C)(ii) as was proposed, would have provided the following:

"A taxable entity produces the product it sells if the taxable entity manufactures, develops, or creates tangible personal property that is incorporated into, installed in, or becomes a component part of the product that it sells. For example:

- (I) A taxable entity produces an electronic device that it sells when the taxable entity produces a computer program, such as an application or operating system, that is installed in the device, even if the device is manufactured by an unrelated party.
- (II) A taxable entity produces a drug that it sells when the taxable entity produces the active ingredient in the drug, even it [sic] the drug is manufactured by an unrelated party."⁶

¹ 41 Tex. Reg. 9625 (2016) (to be codified as an amendment to 34 Tex. Admin. Code § 3.584) (proposed May 20, 2016; effective Dec. 8, 2016) (Tex. Comptroller of Pub. Accounts), available [here](#). Under Tex. Tax Code § 171.002, the standard franchise tax rate is reduced by 50% for taxable entities primarily engaged in retail or wholesale trade. Specifically, the retail/wholesale tax rate is half of the standard rate. For example, in report year 2016, the standard tax rate was .75%, and the retail/wholesale rate was 0.375%.

² Subsection (d)(3)(B) of Rule 3.584 (prior to amendment) is commonly referred to as the Self-Production Test and provides that an entity is primarily engaged in retail or wholesale trade only if less than 50% of the total revenue from activities in retail or wholesale trade comes from the sale of products the entity produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs. Following the amendments discussed within this Alert, the Self-Production Test is now found under subsection (b)(2)(B) of Rule 3.584.

³ 41 Tex. Reg. 3617 (2016) (34 Tex. Admin. Code § 3.584) (proposed May 20, 2016) (Tex. Comptroller of Pub. Accounts), available [here](#).

⁴ Texas Comptroller of Public Accounts, Tax Policy Division: *Qualifying for the 0.5% Tax Rate – Wholesale/Retailer vs. Producer*, Accession No. 201508350L (Aug. 18, 2015), available [here](#).

⁵ 34 Tex. Admin. Code § 3.584(d)(3).

⁶ 41 Tex. Reg. 3617 (2016) (34 Tex. Admin. Code § 3.584) (proposed May 20, 2016) (Tex. Comptroller of Pub. Accounts).

Final Amendments as Adopted – Proposed Language Addressing Self-Production Test Removed

Following release of the proposed amendments, several groups submitted written comments challenging the proposed amendment to the definition of “primarily engaged in retail or wholesale trade,” in particular the additional language affecting the Self-Production Test. In response to the comments, the definition of “primarily engaged in retail or wholesale trade” in the amendments adopted on December 8, 2016, now align more closely with the previous definition in subsection (d)(3) of the former version of Rule 3.584 with “only minor changes to improve readability.”⁷

According to the Comptroller’s statement provided in the *Texas Register* explaining the adopted rule changes, the guidance expressed in Accession No. 201508350L “remains in effect.” However, the Comptroller is still reviewing the public comments submitted and intends to propose amendments to address “some of the concerns expressed in the comments received.” The Comptroller, in his statement in the *Texas Register*, also notes that it does not intend to substantially alter the substance of the guidance set out in Accession No. 201508350L. According to the Comptroller, “[r]emoving the controversial language before adoption of the rule and then proposing another definition in a future rulemaking will allow interested parties the opportunity to comment on the comptroller’s subsequent definition before it is adopted.”⁸

Final Amendments as Adopted – Revised Definition of “Retail Trade”

The amended rules adopted on December 8, 2016, also add a new paragraph (3) to Rule 3.584 providing an updated definition of “retail trade” for reports originally due on or after January 1, 2014.⁹ The meaning of retail trade was originally only referenced as being “under Division...G” of the Standard Industrial Classification Manual. However, the regulation as amended expands the definition of retail trade in line with subsequent amendments to the Texas Tax Code to include apparel rental activities classified under SIC Industry 5999 or 7299, along with SIC Industry Group 753, Automotive Repair Shops; rental-purchase agreement activities regulated by Chapter 92, Business & Commerce Code; activities involving the rental or leasing of tools, party and event supplies, and furniture that are classified as SIC 7359; and heavy construction equipment rental or leasing activities described as SIC Industry 7353.¹⁰

Considerations

Texas franchise taxpayers for which the lower retail/wholesale tax rate is applicable along with taxpayers potentially eligible to apply the retail/wholesale tax rate should continue to monitor the policy of the Comptroller along with any additional proposed regulations which may affect the Self-Production Test. In addition, based on the new definition of “retail trade,” affected taxpayers may wish to consider filing a refund claim for reports originally due on or after January 1, 2014 to apply the retail/wholesale tax rate.

Contacts:

If you have questions regarding the amendments discussed above or other Texas tax matters, please contact any of the following Deloitte Tax professionals:

Russell Brown

Partner

Deloitte Tax LLP, Dallas
+1 214 840 7533
rubrown@deloitte.com

Andrew Robinson

Partner

Deloitte Tax LLP, Houston
+1 713 982 2960
arobinson@deloitte.com

Pamela Downs

Partner

Deloitte Tax LLP, Dallas
+1 214 840 7572
pdowns@deloitte.com

Robert Topp

Managing Director

Deloitte Tax LLP, Houston
+1 713 982 3185
rtopp@deloitte.com

Brad Brookner

Managing Director

Deloitte Tax LLP, Houston
+1 713 982 4897
bbrookner@deloitte.com

Jacob Aguero

Senior Manager

Deloitte Tax LLP, Houston
+1 713 982 4246
jaquero@deloitte.com

⁷ 41 Tex. Reg. 9625, 9626 (2016) (to be codified as an amendment to 34 Tex. Admin. Code § 3.584) (proposed May 20, 2016; effective Dec. 8, 2016) (Tex. Comptroller of Pub. Accounts).

⁸ 41 Tex. Reg. 9625 (2016) (to be codified as an amendment to 34 Tex. Admin. Code § 3.584) (proposed May 20, 2016; effective Dec. 8, 2016) (Tex. Comptroller of Pub. Accounts).

⁹ See *id.*

¹⁰ *Id.*

External Multistate Tax Alert

The authors of this alert would like to acknowledge the contributions of Grace Taylor to the drafting process. Grace is a Senior working in the Houston Multistate Tax Practice of Deloitte Tax LLP.

For further information, visit our website at www.deloitte.com

Follow [@DeloitteTax](https://twitter.com/DeloitteTax)

This alert contains general information only and Deloitte is not, by means of this alert, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This alert is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte shall not be responsible for any loss sustained by any person who relies on this alert.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of which is a legally separate and independent entity. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/about for a detailed description of DTTL and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2016 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited