

Texas Comptroller Releases New Policy for Certain COGS Expenses

May 26, 2015

Overview

On May 13, 2015, the Texas Comptroller (“Comptroller”) released a memorandum announcing a new policy related to the Franchise Tax cost of goods sold (“COGS”) deduction for taxpayers that do not produce the goods they sell (*i.e.*, taxpayers that contract out the manufacturing of their product).¹ In the policy memorandum, the Comptroller stated: “regardless of whether the taxable entity is the producer of the good or not, that taxable entity may include in its COGs deduction research, experimental, engineering, and design activity costs”² In this Tax Alert we summarize the new Comptroller policy.

Comptroller Policy

Under Texas Tax Code (“TTC”) § 171.1012(c)(9), COGS “includes all direct costs of acquiring or producing goods, including costs attributable to research, experimental, engineering, and design activities directly related to the production of goods, including all research or experimental expenditures described by [Internal Revenue Code] Section 174.” The Comptroller’s prior policy limited the COGS deduction for taxpayers that were not the producer of goods to costs involving acquisition, storage, handling, and other costs identified under Texas law. Accordingly, costs directly related to the production of goods that were typically allowed to a producer (*e.g.*, research, experimental, engineering, and design activity costs) were not permitted as a COGS deduction for taxpayers that did not produce the goods they sold.

As discussed in the Comptroller’s memorandum, the Comptroller has now determined that a taxable entity eligible for COGS may claim as COGS those research and experimental costs described by Internal Revenue Code § 174, regardless of whether the taxable entity is considered the producer of the goods. The related Treasury Regulations define research and experimental costs as “expenditures incurred in connection with the taxpayer’s trade or business which represent research and development costs in the experimental or laboratory sense”³ and state that the costs typically include “all such costs incident to the development or improvement of a product.”⁴ Consequently, as stated by the Comptroller, a taxpayer that is not a producer may include in its COGS deduction research, engineering, and design activity costs, including research and experimental expenditures, for goods that it sells. The Comptroller also stated this new policy is effective for all open periods within the statute of limitations and future periods.

Considerations

Taxpayers that do not produce the goods they sell and that have incurred, but failed to include, research, experimental, engineering, and design activities in their COGS calculation may wish to consider whether a refund claim should be filed based upon the Comptroller’s new policy.

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¹ The Comptroller’s memorandum is available [here](#). Note that although the memorandum is dated Apr. 23, 2015, it was released by the Comptroller on May 13, 2015.

² *Id.*

³ Treas. Reg. § 1.174-2(a)(1).

⁴ *Id.* at §§ 1.174-2(a)(1)-(2).

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