

Texas Franchise Tax Rule tightens qualifications for reduced retail/wholesale rate

Overview

On August 30, 2019, the Texas Comptroller of Public Accounts (Comptroller) adopted an amended version of title 34 of the Texas Administrative Code (TAC) § 3.584 (Rule 3.584) (Adopted Rule) that includes revisions and additions of definitions pertaining to a taxpayer's eligibility to utilize the reduced franchise tax rate of 0.375 percent available for entities primarily engaged in retail or wholesale trade (Reduced Rate).¹ The Adopted Rule incorporates several key modifications to the rule as originally proposed in the *Texas Register* (Proposed Rule) on June 21, 2019, including defining the term "produce" under subsection (b)(3) of Rule 3.584.² Specifically, the Comptroller has made modifications to subsection (b)(3) of Rule 3.584 defining "produce" since the rules were originally proposed in June 2019.³

This tax alert summarizes certain comments and provisions of the Adopted Rule, as well as potential tax implications.

Background

Under Rule 3.584(b)(2), a taxable entity is primarily engaged in retail or wholesale trade, and qualified for the Reduced Rate, only if:

- (A) The total revenue from the taxable entity's activities in retail and wholesale trade is greater than the total revenue from its activities in trades other than retail and wholesale trade;
- (B) Less than 50 percent of the total revenue from the taxable entity's activities in retail or wholesale trade comes from the sale of products the taxable entity **produces or products produced** by an entity that is part of an affiliated group to which the taxable entity also belongs, except for those businesses under SIC Manual, Major Group 58 (Eating and Drinking Places). A product is not considered to be produced if modifications made to the acquired product do not increase its sales price by more than 10 percent; and
- (C) The taxable entity does not provide retail or wholesale utilities, including telecommunications services, electricity, or gas.⁴

Emphasis Added.

On June 21, 2019, the Comptroller published a proposed amendment to Rule 3.584 (Proposed Rule) modifying the definition of "primarily engaged in retail or wholesale trade" by adding a definition for the term "produce" under subsection (b)(2)(C) for purposes of determining eligibility for the Reduced Rate.⁵ Prior to the proposed amendment to Rule 3.584, the TAC did not provide a definition of "produce," even though the term is used to determine whether an entity qualifies for the Reduced Rate.⁶

The Proposed Rule defined "produce" as follows:

- (3) Produce - To construct, manufacture, install during the manufacturing or construction process, develop, mine, extract, improve, create, raise, or grow either a product or a component of a product.
 - (A) A taxable entity produces a product that it sells if the taxable entity or an entity that is part of an affiliated group to which the taxable entity also belongs:

¹ 44 Tex. Reg. 4741 (adopted August 30, 2019) (to be codified at 34 Tex. Admin. Code § 3.584) (Tex. Comptroller of Pub. Accounts).

² 44 Tex. Reg. 4741 (adopted August 30, 2019) (to be codified at 34 Tex. Admin. Code § 3.584) (Tex. Comptroller of Pub. Accounts). A copy of the *Texas Register* issue is available [here](#). For further information on the proposed rules, please see Deloitte External Multistate Tax Alert from July 11, 2019, *Texas Comptroller proposes to amend franchise tax rule for retail or wholesale trade*, available [here](#).

³ Compare 44 Tex. Reg. 4741 (adopted August 30, 2019) (to be codified at 34 Tex. Admin. Code § 3.584) (Tex. Comptroller of Pub. Accounts) to the proposed rule found under 44 Tex. Reg. 3082 (proposed June 10, 2019) (to be codified at 34 Tex. Admin. Code § 3.584) (Tex. Comptroller of Pub. Accounts).

⁴ 34 Tex. Admin. Code § 3.584 (emphasis added). The only adopted modification to Rule 3.584(b)(2) was the addition of the following language to subsection (b)(2)(C): "For purposes of this subparagraph, selling telephone prepaid calling cards is not providing telecommunication services." 44 Tex. Reg. 4741 (adopted August 30, 2019) (to be codified at 34 Tex. Admin. Code § 3.584) (Tex. Comptroller of Pub. Accounts). Aside from this addition, subsection (b)(2) of Rule 3.584 remains unchanged.

⁵ 44 Tex. Reg. 3082 (proposed June 10, 2019) (to be codified at 34 Tex. Admin. Code § 3.584) (Tex. Comptroller of Pub. Accounts).

⁶ 34 Tex. Admin. Code § 3.584(b)(2).

- (i) asserts a software copyright on the product or a component of the product;
 - (ii) asserts a patent right under Title 35 of the United States Code or comparable law of a foreign jurisdiction with respect to the product, a component of the product, or the packaging of the product; or
 - (iii) produces a component of the product, or acquires the product and makes a modification to the product, unless the taxable entity can demonstrate that the component or modification does not increase the sales price of the product by more than 10%.
- (B) Except as provided in subparagraph (A) of this paragraph, a taxable entity does not produce a product that it sells if an unrelated party manufactures the product and all components of the product to the taxable entity's specifications.⁷

Prior to adopting the Proposed Rule, the Comptroller requested comments. In the Adopted Rule, the Comptroller made several changes to the Proposed Rule, most notably altering the definition of "produce".

Modification to definition of "produce"

The Adopted Rule adds subsection (b)(3) defining "produce" while broadening the definition as previously outlined under the Proposed Rule.⁸ "Produce" is now defined as follows:

(3) Produce - To construct, manufacture, install during the manufacturing or construction process, develop, mine, extract, improve, create, raise, or grow either a product or a component of a product.

- (A) A taxable entity produces a product that it sells if the taxable entity or an entity that is part of an affiliated group to which the taxable entity also belongs:
- (i) asserts a software copyright **with respect to** the product or a component of the product;
 - (ii) asserts a patent right under Title 35 of the United States Code or comparable law of a foreign jurisdiction with respect to the product, a component of the product, or the packaging of the product; or
 - (iii) produces a component of the product, or acquires the product and makes a modification to the product, unless the taxable entity can demonstrate that the component or modification does not increase the sales price of the product by more than 10%.
- (B) Except as provided in subparagraph (A) of this paragraph, a taxable entity does not produce a product that it sells if an unrelated party manufactures the product and all components of the product to the taxable entity's specifications.⁹

Emphasis Added.

The Adopted Rule potentially narrows the population of taxpayers that may be able to qualify for the Reduced Rate by expanding the type of taxpayers that will be considered to have produced a product. As emphasized above, subsection (3)(A)(i) of Rule 3.584 providing the definition of "produce" now references taxpayers asserting a copyright "with respect to the product" rather than "on the product."¹⁰ The Comptroller in the Preamble indicates this language was modified "to clarify that the assertion of these rights extends beyond the material object that is conveyed and includes the proprietary processes and content associated with the material object."¹¹ As a result of the expanded definition of "produce" as adopted, Rule 3,584, the potential for a variety of taxpayers to qualify for the reduced tax rate across numerous industries may be narrowed.

The Adopted Rule is effective as of September 4, 2019.¹² The Comptroller has clarified subsection (b)(3) under Rule 3.584 will be applied to "reports originally due on or after the effective date of the rule amendment, to the extent that the guidance in subsection (b)(3) may be inconsistent with prior comptroller interpretations."¹³

Considerations

Texas franchise taxpayers currently eligible, or potentially eligible, for the Reduced Rate are advised to consult with their tax advisers to determine potential Texas franchise tax implications and future eligibility for the Reduced Rate.

⁷ 44 Tex. Reg. 3082 (proposed June 10, 2019) (to be codified at 34 Tex. Admin. Code § 3.584) (Tex. Comptroller of Pub. Accounts).

⁸ 44 Tex. Reg. 4743 (adopted August 30, 2019) (to be codified at 34 Tex. Admin. Code § 3.584(b)(3)) (Tex. Comptroller of Pub. Accounts).

⁹ *Id.* (emphasis added).

¹⁰ *Id.*

¹¹ Preamble to 44 Tex. Reg. 4742 (adopted August 30, 2019) (to be codified at 34 Tex. Admin. Code § 3.584) (Tex. Comptroller of Pub. Accounts).

¹² 44 Tex. Reg. 4748 (adopted August 30, 2019) (to be codified at 34 Tex. Admin. Code § 3.584) (Tex. Comptroller of Pub. Accounts).

¹³ Preamble to 44 Tex. Reg. 4743 (adopted August 30, 2019) (to be codified at 34 Tex. Admin. Code § 3.584) (Tex. Comptroller of Pub. Accounts).

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