

Texas Administrative Court Disallows Taxpayer Amendment to COGS Reporting Method

Overview

Recently, the Texas State Office of Administrative Hearings released a hearing decision disallowing a taxpayer's amendment to its franchise tax returns to change its cost of goods (COGS) methodology from the expense to the capitalization method.¹

In this Tax Alert, we summarize the decision and offer some taxpayer considerations.

Background

The Texas Comptroller of Public Accounts audited Taxpayer's franchise tax returns for report years 2009 through 2012 and issued an assessment. Taxpayer requested a redetermination for each audit liability, contending the Comptroller erred in determining the COGS reporting method used by Taxpayer and in otherwise disallowing Taxpayer's proposed amendments to the reports.

For Texas franchise tax purposes, a taxable entity's margin is determined by calculating 70 percent of total revenue from the entity's total business or by subtracting, at the election of the taxpayer, either COGS or compensation.² A taxable entity that elects to use the COGS deduction and that is subject to Internal Revenue Code Section 263A, 460, or 471, may choose to capitalize or expense its COGS.³ The election to capitalize or expense allowable costs is made annually by filing a franchise tax report using the selected method.⁴

Generally, the capitalization method calculates COGS by adding beginning inventory and current-year purchases, and subtracting ending inventory.⁵ Alternatively, the expense method includes current-year purchases and costs and excludes beginning and ending inventory.⁶ Since capitalization of costs recognizes expenses over time, the decision to capitalize or expense COGS when determining the COGS deduction not only impacts COGS for the current year, but the amount of COGS allowed in subsequent years in relation to the goods sold.

According to the hearing decision, Taxpayer's COGS was computed as followed for the years at issue:

Report Year 2008 (Capitalization Method): Taxpayer calculated its franchise tax COGS deduction by using the capitalization method applied on its federal income tax return.

Report Year 2009 (Expense Method): The auditor determined Taxpayer's calculation for report year 2009 was a change in accounting method from report year 2008 because it appeared to use the expense, and not the capitalization, COGS reporting method. The auditor agreed the change to use the expense method for COGS reporting was allowed on the original return. However, the auditor did make adjustments to the COGS deduction by disallowing expenses applicable only to the capitalization method.

¹ Accession No. 201702015H, SOAH Docket Nos. 304-16-3840.13, 304-16-3839.13, 304-16-3846.13 (Feb. 1, 2017), available [here](#).

² Tex. Tax Code § 171.101(a)(1).

³ Tex. Tax Code § 171.1012(g).

⁴ 34 Tex. Admin. Code § 3.588(c)(2).

⁵ If an entity elects to capitalize COGS, it must capitalize each cost allowed that is capitalized on its federal income tax return (FITR). Tex. Tax Code § 171.1012(g); 34 Tex. Admin. Code § 3.588(c)(2)(A)(i). If an entity subsequently elects to begin expensing COGS, the entity may not deduct any cost in ending inventory from a previous report. Tex. Tax Code § 171.1012(g); 34 Tex. Admin. Code § 3.588(c)(2)(A)(ii).

⁶ If an entity elects to expense COGS, a cost incurred before the first day of the period on which the report is based may not be subtracted as COGS. Tex. Tax Code § 171.1012(g); 34 Tex. Admin. Code § 3.588(c)(2)(B)(i). If an entity subsequently elects to capitalize COGS, a cost expensed on a previous report may not be capitalized. Tex. Tax Code § 171.1012(g); 34 Tex. Admin. Code § 3.588(c)(2)(B)(ii).

Report Year 2010 (Capitalization Method): The auditor determined Taxpayer used the capitalization method, which was a change in accounting method from franchise tax report year 2009. The auditor made adjustments to remove duplicated amounts.

Report Year 2011 (Capitalization Method): Taxpayer calculated its COGS deduction in the same manner as report year 2010, using the capitalization method. No changes were made on audit for this year.

Report Year 2012 (Expense Method): The auditor determined Taxpayer's report year 2012 return represented a change in accounting method from report year 2011 to use the expense, and not the capitalization, COGS reporting method. The auditor made several adjustments, including disallowance of expenses applicable only to the capitalization method.

Under Texas regulatory law, a taxable entity may file an amended franchise tax report to correct a mathematical or other error in the report.⁷ However, the COGS election methodology as used on a report may not be changed after the due date or the date the report is filed, whichever is later.⁸

Taxpayer argued it intended to use the capitalization method for every year at issue, and the changes in methodology referenced above were mathematical errors. On audit, the Comptroller did not dispute that Taxpayer was qualified to either capitalize or expense its COGS deductions or that Taxpayer had the option of changing the COGS method from year to year. However, the Comptroller argued Taxpayer's accounting method determined the COGS method applied for each year, and that Taxpayer was barred from amending the COGS method used for each of the reports at issue.

State Office of Administrative Hearing Decision

At the hearing, Taxpayer argued that even if it used the expense method in report year 2009 and 2012, there was no provision in the Texas Tax Code (TTC) that would prohibit a taxable entity from filing amended reports to change its method of COGS reporting. Specifically, Taxpayer argued the interpretation of TTC § 171.1012(g) by the Comptroller in Rule 3.588(c)(2) – which provides that the election on which a report is based may not be changed – exceeded the Comptroller's authority.

The Administrative Law Judge (ALJ) explained that even though TTC § 171.1012(g) was unambiguous, courts may consider the administrative construction of statutory language. As mentioned, the consequences of the choice to capitalize or expense COGS not only impacts the deductions for the current year, but the COGS deductions allowed in the subsequent year, based on the timing differences. According to the ALJ, the Rule 3.588(c)(2) limitation on changes to the COGS methodology properly addressed the accounting complexities and the effects that such changes to the accounting method require. As a result, the ALJ found Rule 3.588(c)(2) did not contradict the plain language of TTC § 171.1012(g), promotes administrative convenience in regard to administration and enforcement of the franchise tax, and was a reasonable interpretation of the statute. As a result, the ALJ found Taxpayer was not allowed to amend its franchise tax returns to change the election of the COGS reporting method under Rule 3.588(c)(2).

Considerations

Texas franchise taxpayers that have elected to use the COGS deduction when calculating taxable margin should confirm that the method elected for calculating COGS is correctly calculated and represented on originally filed returns since the Comptroller's Rule 3.588(c)(2) does not allow taxpayers to elect a change in COGS reporting method on an amended return.

Contacts:

⁷ 34 Tex. Admin. Code § 3.584(f)(1).

⁸ 34 Tex. Admin. Code § 3.588(c)(2).

External Multistate Tax Alert

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