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Texas: “Producer of goods” for reduced franchise tax rate

Representatives from the Texas Comptroller’s office recently convened a “roundtable meeting” to discuss pending revisions to 34 Tex. Admin. Code 3.584 (Rule 3.584) concerning when a taxpayer is considered to be a producer of goods for purposes of the reduced retailer/wholesaler franchise tax rate.

The Comptroller’s office clarified at the outset of the meeting that the proposed changes would simply be clarifications of existing law and would be intended to be effective for all open tax periods under the statute of limitations.

Background

The rules in Texas provide that effective for reports due on or after January 1, 2016, a 0.375% franchise tax rate applies to entities primarily engaged in retail or wholesale trade. All other entities are subject to franchise tax at a rate of 0.75%. A taxable entity is considered primarily engaged in retail or wholesale trade only if certain conditions are met, including that less than 50% of the entity’s total revenue from activities in retail or wholesale trade comes from the sale of products that the taxable entity produces or products produced by an entity that is part of the taxable entity’s affiliated group. In other words, to qualify for the reduced rate, a taxable entity cannot generate 50% or more of its revenue from selling products that are produced by the entity itself or by an affiliate.

The current version of Rule 3.584 provides some guidance on when an entity is considered to have “produced” a product for sale for purposes of the 50% test. Specifically, under the current rule, a product is not considered to be “produced” by a taxable entity if modifications made to an acquired product do not increase its sales price by more than 10%. Thus, currently retailers can make modifications to the products they acquire and sell, and if the sales price is not increased by more than 10%, the product will not be treated as “produced” by the taxable entity. However, if the sales price is increased by more than 10%, this does not mean the product will automatically be treated as “produced.”

Proposed amendments

The Comptroller has proposed a number of amendments to Rule 3.584. Certain of the proposed amendments would expand the guidance on when a taxable entity is considered to produce the products it sells. One amendment, Proposed Rule 3.584 (2)(C)(i), states that a taxable entity "produces" the product that it sells if the taxable entity acquires the product and makes modifications to the product that increase the sales price of the product by more than 10%. Under the current rule, if the sales price of a product increased by more than 10%, the goods could arguably be considered "produced" by the seller—but this result is not mandated. The proposed rule would make this determination automatic.

Proposed Rule 3.584 (2)(C)(ii) would add a new provision stating that a taxable entity is considered to produce 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." The proposed rule provides two examples for applying this provision.

- The first is when a business produces a computer program, such as an application or operating system, which is installed in an electronic device that is manufactured by an unrelated third party and sold by the taxable entity.
- The second example is when a business produces the active ingredient in a drug that is manufactured by an unrelated party.

In both instances, the business producing the incorporated tangible personal property (the software or active ingredient in the drug) is considered to have produced the product itself for purposes of the 50% test (even when an unrelated party is manufacturing the product). Note that it appears that the value of the tangible personal property incorporated into the product is irrelevant for purposes of this provision.

Proposed Rule 3.584 (2)(C)(iii) states that a taxable entity does not produce a product that it sells if the product is manufactured by an unrelated party to the taxable entity's specifications. Although it does not state so explicitly, this appears to be the general rule, which is excepted by 3.584 (2)(C)(ii), discussed above.

Roundtable discussion

Concerning the 10% safe harbor, under the current rule, an entity will not be considered a producer of goods if the purchase price of a good does not change by more than 10% as a result of modifications made by the taxable entity. However, under the revised rule, an entity would automatically be considered a producer of goods if the purchase price is increased by more than 10%.

At the roundtable, industry representatives questioned whether there would be any opportunity for businesses to rebut this determination. An example was given of a butcher that buys a side of beef and turns the side of beef into several different cuts of meat to be sold to customers. It was suggested that the Comptroller's office clarify what it means to modify a product. Most other comments focused on the proposed language that a taxable entity is considered a producer of goods if it manufactures, develops or creates software or other tangible personal property that is incorporated into products that it sells. The concern appeared centered on the fact that, under the proposed rule, software would be treated differently than intangible property, such as a patented formula or process. For example, a company that develops a patented product that is subsequently manufactured by a third party would not be considered a producer, but a company that develops a patented product manufactured by a third party that includes a software component developed by the taxable entity would be considered a producer.

In voicing concerns, an example was given of a surf shop designing a logo and then having it applied to surf boards manufactured by a third party. In this example, the surf shop would not be considered a producer, as the goods are manufactured by a third party and the logo is intangible property. In the second iteration of the example, the surf shop owner creates a new surfboard design with special rudder. The design of the board and rudder is patented, and the manufacturing of the surfboards is again outsourced to a third party. Under this scenario, the surf shop would still be considered a retailer, rather than a producer, because the patent associated with the rudder is an intangible (even if a physical prototype is made). Finally, in a final scenario, the surf shop develops software to use on a feature of the surfboard. In this example, the Comptroller's office confirmed that the surf shop would be considered the producer of the surfboard (although again, the boards are manufactured by an unrelated party). The question asked to Comptroller's office was why would the state treat software code that is replicated by a manufacturer differently than a prototype or a patent, given that both are used by the third-party manufacturer to manufacture goods to another entity's specifications. The officials responded that the difference is that software is considered tangible personal property under Texas law, and owning rights to software code is therefore different than owning a patent or other intangible property. Finally, the state officials noted that although the examples in the proposed regulation address drugs and software, the rationale applies to any tangible personal property incorporated into a product for sale.

KPMG observation

If the rule is adopted as currently proposed, a taxable entity would be considered to be the producer of any goods that include a software component developed by the taxable entity, regardless of the fact that a third party is manufacturing the products. This may affect an entity's ability to qualify for the reduced franchise tax rate—which would look to whether less than 50% of the entity's total revenue from activities in retail or wholesale trade comes from the sale of products the taxable entity produces. The roundtable meeting ended without a clear indication of whether any of the comments would result in further revisions to the rule. However, the Comptroller's office representatives indicated that there would likely be an update in 30 days.

For more information, contact a tax professional with KPMG's State and Local Tax practice:

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