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IRS RULES ON SAME-SEX MARRIAGES

BY CHARLES D. PULMAN, J.D., LL.M., CPA

On June 26, 2013, the United States Supreme Court issued a historic decision extending federal law to same-sex married couples.

In the case of *United States v. Windsor,* 570 U.S. _____, 133 S. Ct. 2675 (2013), ("Windsor"), the Court held that Section 3 of the 1996 Defense of Marriage Act ("DOMA") was unconstitutional as a deprivation of liberty protected by due process and equal protection. Section 3 of DOMA stated that for purposes of federal law, the word "marriage" meant only a legal union between one man and one woman as husband and wife, and the word "spouse" referred only to a person of the opposite sex who is a husband or a wife. As a result of *Windsor,* all federal benefits, rights and privileges are accorded to same-sex married couples.

The *Windsor* case involved a same-sex couple who were married in Canada while living in New York and were residing in New York at the time of death of one of the parties to the marriage. Because New York recognized same-sex marriages, the Court concluded, on those facts, that federal benefits would be extended to the same-sex married couple in *Windsor.* The uncertainty with the *Windsor* opinion is whether its holding extends to a same-sex married couple who were validly married in one state but residing in another state that does not recognize same-sex marriages.

In Ohio, a federal District Judge ruled on July 22, 2013, in a temporary restraining order case, that it is a violation of the Fourteenth Amendment of the United States Constitution for Ohio to discriminate against (not recognize) valid same-

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UNCLE SAM WANTS YOU—TO PAY YOUR 3.8 PERCENT TAX ON NET INVESTMENT INCOME!

BY JASON B. FREEMAN, J.D., CPA

The new 3.8 percent tax on "Net Investment Income" ("NII") imposed by Section 1411 of the Internal Revenue Code is well into its first year of operation. Having served as the source of much confusion and anxiety since the enactment of the Health Care and Education Reconciliation Act of 2010 ("2010 Health Care Tax Act" or the "Act"),[1] the tax on NII—along with related employment tax hikes that were part of the same Act—has been praised by some, criticized by others, and inadvertently overlooked by many.

The Act, which effectively created a hefty new top marginal income tax rate of 43.4 percent on top earners, delayed the implementation date for these taxes until 2013. As a result, many taxpayers are just now feeling the sting—and they are looking for planning opportunities to help mitigate the impact.

THE CONFUSION: IS IT A MEDICARE TAX?

The confusion about the tax on NII is understandable. Although the tax was enacted by the 2010 Health Care Tax Act, and the Internal Revenue Code officially labels it an "Unearned Income Medicare Contribution," its widely

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sex marriages conducted outside Ohio when opposite-sex marriages conducted outside Ohio are recognized by Ohio.

Article 1, Section 32 of the Texas Constitution and Section 6.204 of the Texas Family Code explicitly do not recognize same-sex marriages and explicitly provide that no Texas rights or benefits are to be extended to parties of a same-sex marriage. Thus, a conflict now exists between the application of Texas law to the parties of a valid same-sex marriage and the application of federal tax law to the same parties.

In Texas, the cases of *Texas v. Naylor and Daly and J.B. and H.B. v. State of Texas* presently are pending in the Texas Supreme Court wherein the issue is whether a Texas court has the power to grant a divorce to a same-sex couple who were married outside Texas and were living in Texas at the time of the pending divorce. The Texas Supreme Court held oral arguments in these cases on November 5, 2013.

At the present time, 15 states and the District of Columbia recognize same-sex marriages as valid. Those 15 states are New York, California, Massachusetts, Connecticut, Iowa, Maine, Vermont, Maryland, Washington, New Hampshire, Minnesota, Rhode Island, Delaware, New Jersey and Illinois. The other 35 states, including Texas, do not recognize same-sex marriages. Hawaii appears to be the next state that will recognize same-sex marriages.

In 2004, the General Accounting Office identified 1,138 federal statutory provisions involving marital status as of December 31, 2003, with 198 separate Internal Revenue Code provisions tied to marital status. Since the *Windsor* opinion did not explicitly provide for the application of federal laws to same-sex married couples residing in states that do not recognize same-sex marriages, the application of federal law to same-sex married couples depends upon how each federal agency decides to apply federal law administered by that agency.

For example, in June 2013, Homeland Security announced that the law of the jurisdiction where the marriage was performed would determine whether the marriage is valid for immigration purposes. In addition, the Office of Personnel Management issued a notice in June 2013 that federal benefits would be extended to federal employees and annuitants of a valid same-sex marriage seemingly regardless of residence. Similarly, the Department of Defense has announced that military benefits will be extended to spouses of a valid same-sex marriage regardless of the state where the parties reside. The Social Security Administration apparently looks to state of residence.

On September 18, 2013, the Labor Department issued Technical Release No. 2013-04 stating that for purposes of employee benefit plans under ERISA, the term "spouse" includes same-sex married individuals and the term "marriage" includes a same-sex marriage as long as the marriage is legally recognized in the state or country where the ceremony was performed. State of residence is not relevant. Thus, a valid same-sex marriage is recognized for purposes of ERISA regardless of whether the state of residence recognizes the marriage. In addition, this Technical Release stated that domestic partnerships and civil unions not denominated as a marriage would not be recognized, whether same-sex or opposite-sex.

On August 29, 2013, the Internal Revenue Service ("IRS") issued *Revenue Ruling 2013-17* (the "*Ruling*") stating that the terms "husband," "wife," "spouse" and "marriage" will include individuals to a valid same-sex marriage and that all federal income, gift and estate tax laws will be extended to the parties to a valid same-sex marriage regardless of the state in which the parties reside. The *Ruling* also concludes that federal tax law will not be extended to parties who have entered into a registered domestic partnership, civil union or other similar form of relationship recognized under state law that is not denominated as a marriage under the laws of that state regardless of whether the parties to the marriage are same-sex or different sex.

The *Ruling* states that it is to be applied prospectively as of September 16, 2013. Thus, on and after that effective date, all federal tax laws will apply to the parties to a valid same-sex marriage as long as the marriage was performed in a place, whether in the United States or in a foreign county, that recognized the marriage as valid.

On the same date as the issuance of the *Ruling*, the IRS also issued *Answers to Frequently Asked Questions for Registered Domestic Partners and Individuals in Civil Unions and Answers to Frequently Asked Questions for Individuals of the Same-Sex Who Are Married Under State Law.* Those *FAQs* attempt to clarify the *Ruling* and address additional issues arising out of the *Ruling*.

The *Ruling* and the *FAQs* also provide that a same-sex married couple may file a claim for refund for a prior year for which the statute of limitations is still open if the couple was married during that prior year. The *Ruling* provides that for federal tax returns to be originally filed on or after September 16, 2013, the original return must be filed on the basis of the parties being married, even though, for example, the income tax return may relate to a prior year.

The *Ruling* and the *FAQs* provide that if an original or amended return (claim for refund) claiming marital status is filed for a prior year, then all of the items reported on that return must be filed consistent with marital status.

The IRS recently issued Notice 2013-61 providing special administrative procedures for employers and employees to make claims for refund or adjustments of overpayments of FICA taxes and income tax withholdings with respect to certain benefits provided to same-sex spouses and remuneration paid to same-sex spouses in 2013 and prior years.

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IRS Rules on Same-Sex Marriages, cont. from p. 2

As a result of *Revenue Ruling 2013-17*, same-sex married couples must comply with all federal income, gift and estate tax laws beginning with federal returns (original or amended) filed after September 15, 2013, regardless of whether the state where they live recognizes their marriage (ie, Texas does not recognize same-sex marriages). Thus, for the tax year 2013, a Texas couple will be required to file a federal income tax return as married, whereas the return filed for prior years before September 16, 2013, was filed as single. If the 2012 federal income tax return is filed after September 15, 2013, the return must be filed using married status. In states that do not recognize same-sex marriages but have a state income tax, same-sex married couples in those states will file a federal return based on married and a state return based on not married – an obvious conflict and area of confusion.

If a tax benefit would be realized for a prior year if the couple had filed married, an amended return can be filed for all prior years for which the statute of limitations is open (ie, 3 years from filing or 2 years from payment of tax). However, all transactions for that year must be filed consistent with the married filing status.

The *Windsor* case and *Revenue Ruling 2013-17* also open up significant planning opportunities in the estate and gift tax area for same-sex married couples. In the gift tax area, gifts between spouses are tax-free with the unlimited marital deduction and spouses can split gifts to third parties. In the estate planning area, the unlimited marital deduction is now available to same-sex married couples and the unused lifetime exemption ($5,250,000 presently) of the first spouse to die is now available for use in the estate of the second spouse, provided the "portability" election is made. In appropriate cases, consideration should be given to filing an amended gift or estate tax return for a pre-2013 year to claim the benefits of federal gift or estate tax laws.

The breadth, applicability and consequences of *Windsor* and *Revenue Ruling 2013-17* are only now being understood and analyzed, with many questions still unanswered. Obviously, more guidance will be issued by federal and state agencies in this rapidly advancing area of law.

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Uncle Sam Wants You—To Pay Your 3.8 Percent Tax On Net Investment Income!, cont. from p. 1

perceived association with Medicare is misleading. Contrary to the labels, the revenues generated by the tax on NII are just like any other tax—they go into the General Fund of the United States Treasury, not the Medicare Trust Fund.[2]

The confusion is compounded by the 2010 Health Care Act's simultaneous enactment of several related tax hikes that do, in fact, fund Medicare. Separate from the new tax on NII, the Act leveraged the already-existing Medicare tax infrastructure by increasing the current Medicare tax rate on wages and self-employment income that exceed a threshold amount. And to understand the role of the new tax on NII, one first needs to understand these related employment tax increases.

THE ACT'S IMPACT ON THE EMPLOYMENT TAX REGIME

Under the Federal Insurance Contributions Act ("FICA"), the tax rate on wages earned by an employee (in the absence of temporary tax holidays) is 15.3 percent. This percentage consists of two components: 12.4 percent for Social Security and 2.9 percent for Medicare. The employee pays one-half of each amount through employer withholding—that is, 6.2 percent for Social Security and 1.45 percent for Medicare. The employer is directly responsible for the other half, which it can deduct for income tax purposes.

Similarly, under the Self-Employment Contributions Act ("SECA"), the tax rate on self-employment income (again, in the absence of temporary tax holidays) is 15.3 percent, also consisting of two components: 12.4 percent for Social Security and 2.9 percent for Medicare. The employer-equivalent portion of self-employment taxes is deductible by the self-employed taxpayer.

The 2010 Health Care Tax Act increases the employee portion of the FICA Medicare tax by 0.9 percent—that is, from 1.45 percent to 2.35 percent—on wages above a threshold amount, discussed below, and the employer is required to withhold this additional tax. The employer's "direct" portion, however, remains at 1.45 percent. As a result, the total Medicare tax paid on wages in excess of the "threshold" amount is increased to 3.8 percent (1.45 percent paid by the employer, plus 2.35 percent paid by the employee through withholding).

Likewise, the Act increases the Medicare tax on self-employment income imposed under SECA by 0.9 percent on income above the threshold amount. Thus, the Medicare tax on self-employment income in excess of the "threshold" amount is also 3.8 percent. Notably, because the 0.9 percent

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increase is considered to be part of the employee-equivalent portion, it is not deductible for income tax purposes.

TAX ON NII

In addition to the increases to the Medicare tax rates imposed by FICA and SECA, the newly-created Section 1411 imposes a separate, stand-alone tax of 3.8 percent upon certain individuals, estates, and trusts. The tax is imposed on the *lesser of* the taxpayer's NII or the taxpayer's "modified adjusted gross income" exceeding an applicable threshold. In other words, it is imposed on NII only to the extent a taxpayer's MAGI exceeds the threshold amount. For individuals, the threshold, which is the same threshold that triggers the employment tax increases discussed above, varies according to filing status:

- $250,000 for married filing jointly;[3]
- $125,000 for married filing separately;[4] and
- $200,000 for all others.[5]

The threshold for trusts and estates is significantly lower, and is pegged to the highest tax bracket in Section 1(e) of the Code, which begins at $11,950 for tax year 2013.

HOW IT WORKS

So, how does the tax work? Take, for example, a single person with MAGI of $220,000, which includes $50,000 of NII. The 3.8 percent tax applies to $20,000. Although the taxpayer has $50,000 of NII, the taxpayer's MAGI only exceeds the applicable threshold by $20,000. Thus, the tax base is limited to $20,000.[6] The tax imposed by Section 1411 in this example is $760 (3.8 percent times $20,000).

Let's try another example: a single person with MAGI of $190,000, which includes $50,000 of NII. Here, even though there is $50,000 of NII, there is no tax imposed under Section 1411 because the taxpayer's MAGI does not exceed the applicable threshold amount of $200,000.[7]

WHAT IS NII?

Of course, these examples beg the question: What exactly is NII? Section 1411 creates three general "buckets" of income that constitute NII. These amounts are reduced or offset by deductions that are "properly attributable" to such income. While there are, of course, some nuances, the three buckets generally include:

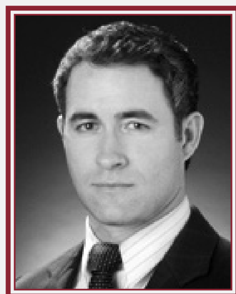
1. Gross interest, dividends, annuities, royalties, and rents that are not derived in the ordinary course of a trade or business;
2. Other gross income derived from either a trade or business that is a passive activity with respect to the taxpayer or a trade or business of trading financial instruments or commodities; and
3. Net gain attributable to the disposition of property, other than property held in a trade or business.

Importantly, gain that is not recognized under Chapter 1 is also generally not recognized for purposes of Section 1411. For example, gains deferred or excluded under Section 121 (sale of a principal residence), Section 453 (installment method), or Section 1031 (like-kind exchange) receive the same treatment under Section 1411.[8]

Similarly, the deferral or disallowance provisions of Chapter 1 generally apply when calculating NII. For example, deductions that are suspended or carried over for Chapter 1 purposes under Section 163(d) (limitation on investment interest), Section 465(a)(2) (at-risk limitations), Section 469(b) (passive activity loss limitations), Section 704(d) (partner loss limitations), and Section 1212(b) (capital loss carryover limitations), are treated in the same manner for computing NII. There are also several elections available that impact the recognition and timing of NII—for example, with respect to the sale of stock in certain S-corporations and the recognition of certain income falling under the Controlled Foreign Corporations provisions and Qualified Electing Fund rules for certain passive foreign investment companies.

COMPLIANCE AND PLANNING

These rules and elections present many planning opportunities for the astute practitioner. Of course, proper planning requires care, as the Treasury warns in the Proposed Regulations that "The IRS will closely review transactions that manipulate a taxpayer's net investment income to reduce or eliminate the amount of tax imposed by section 1411." That being said, the practitioner that is able to properly navigate the complex provisions of the new tax and its proposed regulations will find a number of opportunities to guide their clients on the path to compliance.



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[1] Pub. L. 111-152.

[2] See STAFF OF THE J. COMM. ON TAX'N, 111TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS (Comm. Print. 2011); Net Investment Income Tax, 77 Fed. Reg. 72611, 72613 (to be codified at 26 C.F.R. pt. 1).

[3] I.R.C. § 1411(b)(1).

[4] I.R.C. § 1411(b)(2).

[5] I.R.C. § 1411(b)(3).

[6] Net Investment Income Tax, 77 Fed. Reg. at 72614.

[7] *Id.* at 72613.

[8] *Id.*

[9] *Id.* at 72614.

83RD LEGISLATURE UPDATES THE BUSINESS ORGANIZATIONS CODE

BY KRISTEN M. COX, J.D.

This spring, the 83rd Legislature met to consider legislation addressing a wide variety of issues. Among the bills passed by the legislature were two bills updating the Texas Business Organizations Code ("TBOC"): S.B. 847 and S.B. 849. Effective September 1, 2013, S.B. 847 makes clarifying and other changes to several sections of the TBOC. S.B. 849 became effective on September 1, 2013 as well and amends the TBOC to address social purposes of for-profit corporations. This article will focus on S.B. 847.

SECTION 1

Section 1 of S.B. 847 simplifies the requirements for filing a restated certificate of formation as set forth in §3.059 of the TBOC. No longer does an entity have to identify each added, altered, or deleted provision from the previous certificate of formation. Instead, the entity may now file a restated certificate of formation containing the text of the previous certificate *as amended* by the current amendments as long as that restated certificate of formation also contains accompanying statements explaining (i) that each amendment was made in accordance with the TBOC, (ii) that each amendment was approved in accordance with the TBOC and the entity's governing documents, and (iii) that the restated certificate of formation accurately reflects the text of the prior certificate and all amendments then in effect.

SECTION 2

Section 2 of S.B. 847 amends §7.001(d) of the TBOC to clarify that limited liability companies and partnerships may eliminate the liability of their governing persons through their governing documents. Prior to the amendment contained in S.B. 847, §7.001(d) of the TBOC expressly allowed corporations to use their certificates of formation to limit or eliminate the liability of their governing persons to the corporation or its shareholders, while LLCs and partnerships could only limit or restrict the liability of their governing persons to the entity or its owners. S.B. 847 makes clear that a partnership may use its partnership agreement and an LLC may use either its certificate of formation or its company agreement to either limit or eliminate, rather than merely restrict, the liability of its governing persons to the entity or to its members or partners, as applicable. There are, however, certain exceptions to this ability to eliminate the liability of governing persons. These exceptions can be found in §7.001(c) of the TBOC.

SECTION 3

Section 3 of S.B. 847 amends §11.052(a)(2) of the TBOC to require limited partnerships to provide notices of winding up to all known claimants of the partnership once the entity has decided to wind up and terminate. Prior to this amendment, all partnerships were excepted from the requirement to provide winding up notices to known claimants; however, S.B. 847 narrows that exception, making it applicable only to general partnerships. The amendment to §11.052(a)(2) remedies an unfair result caused by the interaction of §11.052(a) and §11.359 of the TBOC. Under §11.359, claims against a "filing entity" are extinguished three years after the termination of the filing entity. Because limited partnerships are filing entities, all claims against limited partnerships are extinguished three years after the termination of the limited partnership. Under the old wording of §11.052(a)(2), a claimant of a limited partnership was not entitled to notice and therefore could be deprived of a fair opportunity to timely pursue its claims against the terminated limited partnership prior to the extinguishment of those claims. Now, so long as a limited partnership complies with the notice requirement set forth in §11.052(a)(2), a creditor of that limited partnership should have a minimum of three years to pursue its claims before those claims are extinguished by §11.359 of the TBOC.

SECTION 4

Section 4 of S.B. 847 amends §21.301(1) of the TBOC to reword the definition of "distribution limit" with regard to consuming assets corporations. This amendment does not substantively change the definition.

SECTIONS 5 AND 10

Sections 5 and 10 of S.B. 847 add a new §101.052(e) and a new §154.104 to the TBOC to address the rights of third parties in company agreements and partnership agreements, respectively. These new sections make clear that LLCs may provide rights to third parties under their company agreements and partnerships may provide rights to third parties under their partnership agreements. An example of the third party rights that are often addressed in company agreements and partnership agreements are indemnification rights of officers or employees who are not parties to these agreements.

SECTION 6

Section 6 of S.B. 847 amends §101.605 of the TBOC to expand the powers of a series of a series LLC. The revised §101.605(3) expressly allows a series of a series LLC to acquire and sell assets as opposed to merely holding title to those assets, which is how the subsection previously read. The

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amendment contained in S.B. 847 also adds a new subsection (5) to §101.605, which is a catch-all provision allowing a series of a series LLC to "exercise any power or privilege as necessary or appropriate to the conduct, promotion, or attainment of the business, purposes, or activities of the series."

SECTIONS 7 AND 8

Sections 7 and 8 of S.B. 847 amend §101.609 of the TBOC to make clear which portions of Title 1 of the TBOC apply to each series of a series LLC. Title 1 of the TBOC is often referred to as the hub of the TBOC and contains general provisions applicable to all entities. S.B. 847 adds a new subsection (c) to §101.609 of the TBOC and states that Subchapters C and D of Chapter 3 and Subchapter F of Chapter 10 of the TBOC apply to the series of a series LLC and to the governing persons and officers of those series. Subchapter C of Chapter 3 of the TBOC generally sets forth the role of governing persons and officers of a Texas entity and gives them a right to rely on information and opinions of other officers or employees of the entity, attorneys, CPAs, investment bankers, or anyone else the officer or governing person believes has expertise in the matter at issue when that officer or governing person is making decisions on behalf of the entity. Subchapter D of Chapter 3 lists the books and records that all filing entities must keep and addresses the rights of examination that owners and governing persons have with regard to those books and records. Finally, Subchapter F of Chapter 10 of the TBOC governs the transfer or disposition of the property of a Texas entity. Of course, these Subchapters in Title 1 are only applicable to the series of a series LLC to the extent that the Subchapters do not conflict with the provisions of Subchapter M of Chapter 101 of the TBOC.

SECTION 9

Section 9 of S.B. 847 adds a new §101.622 to the TBOC to clarify that the individual series of a series LLC are not to be treated as separate domestic entities or organizations for purposes of Chapter 101 and Title 1 of the TBOC. This is consistent with the Texas Comptroller's treatment of the series of a series LLC. The Comptroller requires all series of a series LLC to be reported on the franchise tax return of the series LLC rather than on separate franchise tax returns. Interestingly, in 2010 the Internal Revenue Service issued a Notice of Proposed Rulemaking which proposes to treat each series of a series LLC as a separate entity for federal tax purposes regardless of treatment of the series by the state in which the series LLC was formed.

SECTION 11

Finally, Section 11 of S.B. 847 repeals §24.003(c) of the Texas Business & Commerce Code ("TB&CC"). Section 24.003 of the TB&CC is part of Texas's Uniform Fraudulent Transfer Act ("TUFTA") and sets forth the test for determining the solvency of an entity. Under the TUFTA, a transfer is considered fraudulent as to a present creditor when the transfer is made without receiving reasonably equivalent value in return and the entity is insolvent at the time of the transfer or becomes insolvent as a result of the transfer. Prior to the amendment made by S.B. 847, a court would look not only to the debts and assets of a partnership when determining solvency of that partnership for purposes of the TUFTA but also to the non-partnership debts and assets of the general partner of the partnership. Unamended, §24.003 caused problems for creditors of limited liability partnerships because a general partner having substantial assets could prevent a partnership from being deemed insolvent despite the lack of assets of the partnership itself, thus depriving the creditor of a remedy under the TUFTA even though the creditor also would be unable to recover against the general partner of the LLP. This amendment to the TB&CC increases the likelihood that a creditor of an LLP will be able to obtain relief under the TUFTA for improper transfers made when an LLP has few or no assets despite the substantial assets of its general partner.

If you have any questions regarding the recently enacted amendments to the TBOC, please contact Kristen Cox at 214-749-2403 or kcox@meadowscollier.com.

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TEXAS COMPTROLLER REVISES RULE ON COST OF GOODS SOLD

BY T. L. FAHRING, J.D., LL.M.

The Texas Comptroller of Public Accounts has recently revised her rule regarding the cost of goods sold deduction under the Texas franchise tax. The revised rule expands the types of labor costs that may be fully deducted as cost of goods sold.

I. DEDUCTIBILITY OF LABOR COSTS AS COST OF GOODS SOLD

Under the Texas Tax Code, a taxable entity may elect to calculate its franchise tax by deducting cost of goods sold.[1] Cost of goods sold includes all direct costs of acquiring and producing goods that are sold to customers in the ordinary course of business, including certain labor costs.[2]

On the other hand, indirect and administrative overhead costs attributable to the acquisition or production of goods are deductible only up to four percent of the taxable entity's total indirect and administrative overhead costs.[3] Indirect and administrative overhead costs include costs attributable to security services, legal services, data processing services, accounting services, personnel operations, and general financial planning and financial management costs.

Some labor costs, however, are never deductible as cost of goods sold. Such costs include selling costs, distribution costs, advertising costs, rehandling costs, strike expenses, officer's compensation, and compensation paid to an undocumented worker for the production of goods.[4]

Thus, labor costs can be divided into four categories for purposes of determining their deductibility as cost of goods sold under the Texas franchise tax:

(1) Labor costs that are direct costs attributable to the acquisition or production of property - fully deductible.

(2) Labor costs that are indirect and administrative overhead costs and that are attributable to the acquisition or production of goods - deductible in an amount not to exceed four percent of total indirect and administrative overhead costs.

(3) Labor costs that are indirect and administrative overhead costs and that are not attributable to the acquisition or production of goods - not deductible.

(4) Labor costs that are specifically excluded from the cost of goods sold deduction - not deductible.

The Comptroller's revised rule impacts the first two categories and represents a shift in the Comptroller's policy regarding the manner in which labor costs are characterized as direct costs or indirect and administrative overhead costs.

II. REVISED COMPTROLLER RULE 3.588

Under the Comptroller's former policy regarding cost of goods sold, direct labor costs included only the labor of those persons who physically acquired or produced goods that were sold.[5] Supervisory labor was not a direct cost and was only deductible subject to the four percent limitation of total indirect or administrative overhead costs.

In June 2013, the Texas Comptroller revised her rule on the cost of goods sold deduction. The language of the rule as revised now reads:[6]

"A taxable entity now may include in its cost of goods sold calculation labor costs, other than service costs, that are properly allocable to the acquisition or production of goods and are of the type subject to capitalization or allocation under Treasury Regulation 1.263A-1(e) or 1.460-5 as direct labor costs, indirect labor costs, employee benefit expenses, and other related costs, without regard to whether the taxable entity is required to or actually capitalizes such costs for federal income tax purposes."

The revised rule also expands the types of costs that are considered labor costs to include:[7]

"W-2 wages, IRS Form 1099 payments for labor, temporary labor expenses, payroll taxes, pension contributions, and employee benefit expenses, including, but not limited to, health insurance and per diem reimbursements for travel expenses, to the extent deductible for federal tax purposes."

The Comptroller's revised rule excludes service costs from being deducted in full as cost of goods sold. The rule defines service costs as:[8]

"Indirect costs and administrative overhead costs that can be identified specifically with a service department or function, or that directly benefit or are incurred by reason of a service department or function. For purposes of this section, a service department includes personnel (including costs of recruiting, hiring, relocating, assigning, and maintaining personnel records or employees); accounting (including accounts payable, disbursements, and payroll functions); data processing; security; legal; general financial planning and management; and other similar

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departments or functions."

The Comptroller's stated policy behind these revisions was to expand the types of labor costs that are fully deductible as cost of goods sold so as to include certain indirect labor costs, such as supervisory labor, that can be directly attributed to production or resale activities.[9]

However, indirect or administrative overhead costs, including service costs, remain deductible as cost of goods sold only to the extent that they are allocable to the acquisition and production of goods, and even then the deduction of such costs is limited to four percent of the taxable entity's total indirect or administrative overhead costs.[10] In addition, the revised rule does not change the types of labor costs that are specifically excluded from the cost of goods sold deduction.

III. TREASURY REGULATION 1.263A-1(e)

The determination of whether labor costs are fully deductible as cost of goods sold under the Texas franchise tax is now tied to whether the same costs are of a type subject to capitalization under Treasury Regulation § 1.263A-1(e). The Comptroller has emphasized that labor costs that are deductible under Treasury Regulation 1.263A-1(e) are fully deductible as cost of goods sold even if the taxable entity is not required to or does not actually capitalize such costs for federal income tax purposes.[11]

Under I.R.C. § 263A, a taxpayer must capitalize all directs costs and certain indirect costs allocable to property produced or acquired for resale.[12]

Treasury Regulation § 1.263A-1(e) defines direct labor costs to include:[13]

"[T]he costs of labor that can be identified or associated with particular units or groups of units of specific property produced. For this purpose, labor encompasses full-time and part-time employees and independent contractors . . . . Elements of direct labor costs include basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay . . . shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan."

Indirect costs that are required to be capitalized under Treasury Regulation §1.263A-1(e) include:[14]

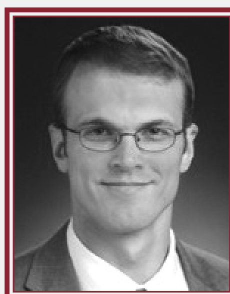
"[A]ll labor costs . . . that cannot be directly identified or associated with particular units or groups of units of specific property produced or property acquired for resale (e.g., factory labor that is not direct labor). As in the case of direct labor, indirect labor encompasses full-time and part-time employees, as well as contract employees and independent contractors."

The Treasury Regulations go on to identify specific labor costs that must be capitalized in a variety of contexts, including purchases costs, handling costs, and storage or warehousing costs. For example, the Treasury Regulations require that labor costs that form part of purchasing costs must be capitalized.[15] Labor costs that form part of purchasing costs include the selection of merchandise, the maintenance of stock assortment and volume, the placement of purchase orders, the establishment and maintenance of vendor contacts, and the comparison and testing of merchandise.

Thus, it is important for taxpayers to examine the Section 263A regulations in order to determine which labor costs are required to be capitalized under the federal income tax and are therefore fully deductible as cost of goods sold according to the Comptroller's revised rule.

CONCLUSION

The Comptroller's revised rule on the cost of goods sold deduction under the Texas franchise tax expands the types of labor costs that are fully deductible as cost of goods sold, tying this determination to whether the same costs may be capitalized under Treasury Regulation § 1.263A-1(e). Therefore, Taxpayers should reexamine their labor costs under the revised rule and Treasury Regulation § 1.263A-1(e) to determine whether such costs may be fully deductible.



THOMAS L. FAHRING III

Thomas L. Fahring III is an associate with the firm whose practice focuses on Income Tax and Business Planning, Income Tax Litigation, Estate and Gift Tax Litigation and State Tax Planning and Litigation.

tfahring@meadowscollier.com

1 Tex. Tax Code Ann. §171.101(a)(1)(B)(ii)(a).

2 Tex. Tax Code Ann. § 171.1012(c)(1).

3 Tex. Tax Code § 171.1012(f).

4 Tex. Tax Code Ann. § 171.1012(e).

5 STAR 201112315L (Dec. 2011).

6 34 Tex. Admin. Code § 3.588(d)(1).

7 34 Tex. Admin. Code § 3.588(d)(1)(A).

8 34 Tex. Admin. Code § 3.588(b)(9).

9 STAR 201307727L (July 16, 2013).

10 STAR 201307727L (July 16, 2013).

11 34 Tex. Admin. Code § 3.588(d)(1); STAR 201307727L (July 16, 2013).

12 Treas. Reg. § 1.263A-1(e)(1).

13 Treas. Reg. § 1.263A-1(e)(2)(B).

14 Treas. Reg. § 1.263A-1(e)(3)(ii)(A).

15 See Treas. Reg. §§ 1.263A-1(e)(3)(ii)(F), 1.263A-3(c)(3)(i).

THE FIRM WELCOMES THE FOLLOWING ATTORNEY:

AARON P. BORDEN, J.D., CPA

Mr. Borden practices in the areas of income tax litigation, estate and gift tax litigation, white collar and government regulatory litigation, and state tax planning and litigation. He is a Certified Public Accountant. Mr. Borden received his J.D. from The University of Texas School of Law in 2010. While at The University of Texas School of Law is was Staff Editor, *Texas Journal of Oil, Gas & Energy Law* and he received the Judge Harry Lee Hudspeth Endowed Presidential Scholarship, Townes Hall Scholarship and the Dean's Achievement Award for the highest grade in Federal Income Tax. He received his B.S., *magna cum laude,* from Wayland Baptist University in 2004. Mr. Borden was admitted to practice in Texas in 2013.

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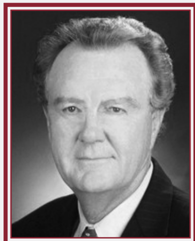
FIRM NEWS

The firm celebrated its 30th Anniversary on September 5, 2013.

The firm wishes to congratulate the following attorneys for being named to the list of **2013 Texas Super Lawyers** – Robert Don Collier, David E. Colmenero, William R. Cousins, III, Joel N. Crouch, Charles D. Pulman, Josh O. Ungerman and Michael A. Villa, Jr. for the tax practice area. Charles M. Meadows, Jr. and Sarah Q. Wirskye for the Criminal Defense: White Collar practice area. Congratulations to Charles M. Meadows, Jr. for being named to the Texas – The Top 100 for ranking top of the list in the **2013 Texas Super Lawyers** nominations, research and blue ribbon review process.

The firm wishes to congratulate the following attorneys for their selection as **2013 Top Rated Lawyers in White Collar Criminal Defense Law** by American Lawyer Media and Martindale-Hubbell – William R. Cousins, III, Joel N. Crouch, Michael E. McCue, Charles M. Meadows, Jr., David N. Reed and Josh O. Ungerman.



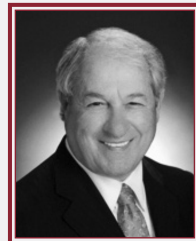
Robert Don Collier

David E. Colmenero

William R. Cousins III

Joel N. Crouch

Michael E. McCue



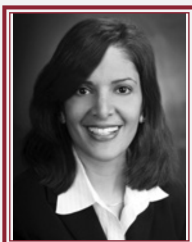
Charles M. Meadows, Jr.

Charles D. Pulman

David N. Reed

Josh O. Ungerman

Mike A. Villa, Jr.



Sarah Q. Wirskye

UPCOMING SPEAKING ENGAGEMENTS

FOR COMPLETE SPEAKING ENGAGEMENT INFORMATION, PLEASE VISIT WWW.MEADOWSCOLLIER.COM AND CLICK ON THE "NEWS & EVENTS" TAB ON THE HOME PAGE.

12.10.13
SAN ANTONIO, TX
TSCPA CPE Expo

JOEL CROUCH
WHAT TO EXPECT IN 2014 FROM A RAPIDLY CHANGING IRS

12.11.13
SHREVEPORT, LA
Louisiana Society of CPAs Tax Conference

TREY COUSINS
"SO YOU THOUGHT THE STATUTE OF LIMITATIONS WAS SIMPLE..."

12.12.13
LAS VEGAS, NV
2013 ABA 30th Annual National Institute on Criminal Tax Fraud and Third National Institute on Tax Controversy

CHUCK MEADOWS
PANEL PRESENTATION "PROSECUTION AND DEFENSE OF A KLEIN CONSPIRACY"

12.12.13
NEW ORLEANS, LA
Louisiana Society of CPAs Tax Conference

TREY COUSINS
"SO YOU THOUGHT THE STATUTE OF LIMITATIONS WAS SIMPLE..."

12.13.13
ARLINGTON, TX
TSCPA CPE Expo

ANTHONY DADDINO
"WHAT TO EXPECT IN 2014 FROM A RAPIDLY CHANGING IRS"

12.17.13
HOUSTON, TX
TSCPA CPE Expo

JOEL CROUCH
"WHAT TO EXPECT IN 2014 FROM A RAPIDLY CHANGING IRS"

01.14.14
MIDLAND, TX
Midland-Odessa Business and Estate Council

DAVID COLMENERO AND STEPHEN BECK
"FEDERAL AND STATE TAX CONSIDERATIONS FOR THE SALE OR ACQUISITION OF A BUSINESS IN A REBOUNDING ECONOMY"

01.21.14
SAN ANTONIO, TX
San Antonio Estate Planners Council

TREY COUSINS
"TBA"

01.24.14
FORT WORTH, TX
American Association of Attorney - CPAs

JOEL CROUCH
"TBA"

01.29.14
CORPUS CHRISTI, TX
Corpus Christi Chapter/TSCPA 56th Annual Tax Conference

JOEL CROUCH
"SELF EMPLOYMENT TAX FOR LLCS AND S CORPS"

MATT BEARD
"PROFIT AND LOSS ALLOCATIONS, DISTRIBUTIONS, AND OTHER KEY TAX PROVISIONS FOR PARTNERSHIP AGREEMENTS"

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02.05.14
TYLER, TX
East Texas Estate Planning Council

ANTHONY DADDINO
"COOKING WITH UNCLE SAM: ARE YOUR CLIENTS OR THEIR TRANSACTIONS ON THE FRONT BURNER?

02.06.14
BEAUMONT, TX
Southeast Texas Chapter/ TSCPA

JASON FREEMAN
"BANK SECRECY ACT AND MONETARY REPORTING"

02.11.14
MIDLAND, TX
Midland-Odessa Business and Estate Council

ANTHONY DADDINO
"COOKING WITH UNCLE SAM: ARE YOUR CLIENTS OR THEIR TRANSACTIONS ON THE FRONT BURNER?"

02.20.14
AUSTIN, TX
State Bar of Texas
LGBT Panel Webcast

CHARES PULMAN
ALAN DAVIS
"SAME-SEX MARRIAGES - THE QUAGMIRE CONTINUES AFTER WINDSOR."

03.20.14
BEAUMONT, TX
Southeast Texas Chapter/ TSCPA

JASON FREEMAN
"EMPLOYMENT TAX AND COMPLIANCE FOR BUSINESS"

03.27.14
CORPUS CHRISTI, TX
Corpus Christi Estate Planning Council

TREY COUSINS
"FLPS"

04.23.14
AUSTIN, TX
Estate Planning Council of Central Texas

JOSH UNGERMAN
"FRAUD, OMISSIONS, ERRORS AND MISSED DEADLINES"

05.08.14
MIDLAND, TX
Midland Memorial Foundation and Midland College

CHARLES PULMAN
"SAME SEX MARRIAGES - FEDERAL TAX LAW AFTER WINDSOR AND REVENUE RULING 2013-17"

05.19.14
DALLAS, TX
2014 TSCPA Nonprofit Organizations Conference

ALAN DAVIS
"WHAT'S NEW IN THE WORLD OF PRIVATE FOUNDATION EXCISE TAXES"

MEADOWS COLLIER ATTORNEYS

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