

## Texas enacts provisions creating a phased-in deduction for certain costs relating to federal government contracts

### Overview

On June 14, 2019, Texas Governor Greg Abbott signed House Bill 1607 (HB 1607) into law.<sup>1</sup> HB 1607 expands the compensation and cost of goods sold (COGS) deductions for taxpayers in the aerospace industry who have contracts with the federal government.<sup>2</sup> HB 1607 defines "aerospace costs" and allows for the inclusion of additional costs in a taxable entity's calculation of its COGS and compensation deductions effective on January 1, 2020.<sup>3</sup>

This tax alert summarizes these law changes, effective dates, and discusses a few considerations relating to the new provisions.

### Modifications under HB 1607

HB 1607 amends Texas Tax Code (TTC) § 171.101, regarding the determination of taxable margin, by adding subsections (e) and (f).<sup>4</sup> Subsection (e) defines "aerospace costs" as "costs not already subtracted in the COGS or compensation deductions that are properly allocated and incurred under the Federal Acquisition Regulation (48 C.F.R. Chapter 1) . . . ."<sup>5</sup>

Under these provisions, aerospace costs include costs subject to the requirements of 48 C.F.R. Chapter 2 or Chapter 18 for contracts or subcontracts for the sale of goods or services to the federal government by a taxable entity in the aerospace industry that is engaged in activities described by the following North American Industry Classification System codes:

- 334511 (Search, Detection, Navigation, Guidance, Aeronautical, and Nautical System and Instrument Manufacturing),
- 3364 (Aircraft Manufacturing, Engine Parts Manufacturing),
- 3399 (Miscellaneous Manufacturing),
- 5413 (Engineering Services),
- 5415 (Computer Related Systems),
- 5416 (Scientific and Technical Consulting Services, Other Management Consulting Services), or
- 5419 (All Other Professional, Scientific, and Technical Services).<sup>6</sup>

HB 1607 broadens the costs incurred under government contracts to include those costs of services and subcontracting expenses not previously included under the prior provisions.<sup>7</sup> However, as detailed below, these costs are phased-in, in contrast to historical COGS or compensation expenses that may be fully deductible.<sup>8</sup> Thus, Texas taxpayers under contract with the federal government and providing goods or services in the aerospace industry may be able to include additional costs of compensation and COGS in their taxable margin calculations.

### Five year phase-in

HB 1607 mandates a five year phase-in for the newly defined aerospace costs and resulting COGS and compensation deductions.<sup>9</sup> Subsection (f) specifies in computing the sum, a taxable entity may add to other amounts described by the following:

<sup>1</sup> Acts of 86th Legislature, Regular Session, H.B. 1607, § 2, Chapter §171, Tax Code, is amended by adding subsections (e) and (f), located [here](#).

<sup>2</sup> Acts of 86th Legislature, Regular Session, H.B. 1607, § 2, amending Tex. Tax Code § 171.101.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> Acts of 86th Legislature, Regular Session, H.B. 1607, § 2, adding Tex. Tax Code § 171.101(e).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* See also Tex. Tax Code § 171.101.

<sup>8</sup> See Tex. Tax Code § 171.101; Tex. Tax Code § 171.1012; Tex. Tax Code § 171.1013.

<sup>9</sup> Acts of 86th Legislature, Regular Session, H.B. 1607, § 2, adding Tex. Tax Code § 171.101(f).

- 1) for a report originally due on or after January 1, 2020, and before January 1, 2021, 20 percent of aerospace costs;
- 2) for a report originally due on or after January 1, 2021, and before January 1, 2022, 40 percent of aerospace costs;
- 3) for a report originally due on or after January 1, 2022, and before January 1, 2023, 60 percent of aerospace costs;
- 4) for a report originally due on or after January 1, 2023, and before January 1, 2024, 80 percent of aerospace costs; and
- 5) for a report originally due on or after January 1, 2024, 100 percent of aerospace costs.<sup>10</sup>

H.B. 1607 is effective on January 1, 2020,<sup>11</sup> thus the provisions are effective for tax periods beginning on or after January 1, 2020.

## Considerations

Taxpayers engaged in the aerospace industry under federal contracts may want to review the new definition of aerospace costs, which could impact the COGS or compensation deduction. Taxpayers should be aware that these new aerospace costs while deductible are subject to a phase-in, as compared to historical COGS expenses that may be fully deductible. Accordingly, taxpayers may want to review any relevant calculation to determine the proper deductibility of various costs.

## Contacts:

If you have questions regarding the HB 1607 changes in Texas franchise law or other Texas tax matters, please contact any of the following Deloitte professionals:

**Robert Topp**  
**Managing Director**  
Deloitte Tax LLP, Houston  
+1 713 982 3185  
[rtopp@deloitte.com](mailto:rtopp@deloitte.com)

**Jacob Aguero**  
**Partner**  
Deloitte Tax LLP, Houston  
+1 713 982 4246  
[jaquero@deloitte.com](mailto:jaquero@deloitte.com)

**Lauren Rothman**  
**Senior Manager**  
Deloitte Tax LLP, Houston  
+1 713 982 2462  
[lrothman@deloitte.com](mailto:lrothman@deloitte.com)

**Scott Bedunah**  
**Senior Manager**  
Deloitte Tax LLP, Dallas  
+1 214 840 1722  
[scbedunah@deloitte.com](mailto:scbedunah@deloitte.com)

**Grace Taylor**  
**Manager**  
Deloitte Tax LLP, Houston  
+1 713 982 3809  
[grtaylor@deloitte.com](mailto:grtaylor@deloitte.com)

**For further information, visit our website at [www.deloitte.com/us/multistatetax](http://www.deloitte.com/us/multistatetax)**

**Follow [@DeloitteTax](https://twitter.com/DeloitteTax)**

This alert contains general information only and Deloitte is not, by means of this alert, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This alert is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte shall not be responsible for any loss sustained by any person who relies on this alert.

### About Deloitte

Deloitte refers to Deloitte Tax LLP, a subsidiary of Deloitte LLP. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2019 Deloitte Development LLC. All rights reserved.

<sup>10</sup> Acts of 86th Legislature, Regular Session, H.B. 1607, § 2, adding Tex. Tax Code § 171.101(f).

<sup>11</sup> Acts of 86th Legislature, Regular Session, H.B. 1607, § 3.