

Texas Comptroller Ruling - Taxpayer May Not Include Costs of Purchasing Franchise Agreement in Cost of Goods Sold Deduction

Overview

On May 29, 2018, the Texas Comptroller of Public Accounts (Comptroller) released a ruling addressing whether an automotive retailer (Taxpayer) was entitled to include the purchase price of franchise rights obtained as part of a recent acquisition within its costs of goods sold (COGS) for purposes of the Texas franchise tax (commonly referred to as the Texas margin tax) under Texas Tax Code (TTC) §§ 171.001 and 171.1012.¹

As described in more detail below, the Comptroller ultimately determined the amount paid by the Taxpayer for the car manufacturer's franchise rights did not qualify as deductible direct COGS under TTC § 171.1012(d)(10), but instead were indirect COGS and affirmed the refund denial.

In this tax alert, we summarize the Comptroller's decision as well as offer some taxpayer considerations.

Background

Taxpayer operated as an automobile retailer that sold automobiles and automotive parts during report years 2010, 2011, 2012, and 2013 (collectively, Report Years).² During the Report Years, Taxpayer acquired several existing automobile dealerships from Seller.³ Pursuant to the purchase agreement, Taxpayer agreed to purchase the tangible and intangible assets of Seller's company, including "all rights of Seller under contracts assigned to and assumed by [Taxpayer]" and "all other intangible rights and interests" related to the business.⁴ This intangible right included the right to represent an automobile manufacturer (Manufacturer) that had previously contracted with Seller. Under the purchase agreement, Seller agreed to Seller's franchise agreement with Manufacturer. As explained within the ruling, the transfer of these intangible rights was key to the purchase agreement, and Manufacturer's approval of the new franchisee was a condition precedent.⁵ After executing the purchase agreement, the Manufacturer agreed to allow Taxpayer to operate as a franchisee for its brand.⁶

According to Taxpayer, the franchise agreement with a manufacturer was critical to the business operations of its automobile dealership because the services it provided under the agreements generated the greatest gross profit per department.⁷ Without it, Taxpayer would have been unable to acquire inventory, offer manufacturer-related services such as warranty repairs, factory-authorized service, or reselling used parts and vehicles.⁸ As noted in the ruling, Taxpayer had no upfront payment obligation to the Manufacturer to begin operating the dealership, which was similar to most manufacturer's franchise agreement.⁹

After finalizing the purchase agreement, Taxpayer filed amended returns requesting a refund for the Report Years including in its COGS deduction, among other costs, the amounts paid related to Manufacturer's franchise agreement.¹⁰ Taxpayer claimed the costs related to the franchise agreement were qualified licensing and franchise fees under TTC §

¹ Texas Comptroller of Public Accounts, Accession No. 201805027H, SOAH Docket Nos. 304-17-3294.13, 304-17-3295.13, 304-17-3296.13, 304-17-3297.13, CPA Hearing Nos. 113,131, 113,132, 113,133, 113,134 (May 29, 2018), available [here](#).

² *Id.* *5.

³ *Id.* *6.

⁴ *Id.* *6.

⁵ *Id.* *5-8.

⁶ *Id.* *8.

⁷ *Id.* *7-8.

⁸ *Id.* *8.

⁹ *Id.* *8.

¹⁰ *Id.* *8.

171.1012(d)(10).¹¹ On review, the auditor granted the refund request in part, but excluded the franchise agreement amounts based on a determination such amounts did not qualify as direct COGS.¹²

Comptroller's interpretation of franchise and licensing fees that qualify for COGS

Under TTC § 171.101(a), a taxable entity may determine the total revenue from its entire business by subtracting from total revenue its COGS as determined under TTC § 171.1012.¹³ COGS includes all direct costs of acquiring or producing goods, along with other costs related to the taxable entity's goods.¹⁴ Qualifying direct COGS include "licensing or franchise costs, including fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right directly associated with the goods produced."¹⁵

The Administrative Law Judge (ALJ) emphasized the limited guidance from the both the Comptroller and the courts on the related COGS under TTC § 171.1012(d), finding only one Comptroller policy statement and one appellate decision on point.¹⁶ The Comptroller's letter ruling that was cited by the ALJ related to the license and franchise fees.¹⁷ In this letter ruling, the taxpayer had entered into concession agreements and paid facility owners and promoters a percentage of receipts from the sale.¹⁸ The taxpayer claimed these payments estimated the fair market value of the exclusive right to sell concessions and sought to have them included as licensing fees.¹⁹ However, the Comptroller's Tax Policy division determined these payments were more appropriately categorized as "selling costs" under TTC § 171.1012(e)(2) and thus not deductible as COGS.²⁰

As part of that previous letter ruling, the ALJ had relied on a 2017 appellate court decision that examined whether a cost qualified for the COGS deduction under TTC § 171.1012(d).²¹ In the appellate decision, the taxpayer made a one-time payment to an asbestos trust fund, which it claimed as a "quality control" cost.²² Based on examples provided by the legislature on what constitutes a "quality control" costs, the court construed TTC § 171.1012(d) narrowly and found the costs must be "in relation to the taxable entity's goods" (*i.e.*, quality control costs are those actually meant to improve the quality of the goods themselves) and held the payment was not a cost of quality control includable in COGS.²³

Administrative Law Judge's decision

Based on the guidance discussed above, the ALJ held Taxpayer's costs related to Manufacturer's franchise agreement did not qualify as direct COGS.²⁴ Relying on the appellate court's analysis of TTC § 171.1012(d)(9), the ALJ referenced the examples of licensing and franchise fees provided by the legislature in TTC § 171.1012(d)(10): "fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right directly associated with the goods produced" against the amounts claimed by Taxpayer.²⁵ As part of its opinion, the ALJ emphasized that franchise rights can only be conveyed by a franchisor (*i.e.*, Manufacturer), as opposed to Seller.²⁶ Consequently, the ALJ found Taxpayer conflated the asset purchase and franchise agreements because the intangible assets conveyed by the asset purchase agreement to Taxpayer did not include the franchise rights and thus could not be considered part of the COGS.²⁷ As part of the transfer of franchise rights to Taxpayer from Seller, Taxpayer did not directly obtain the rights from Manufacturer or pay a fee to Manufacturer. Once the ALJ determined the franchise rights were not included in Taxpayer's purchase of intangible assets, the ALJ thereafter found the remaining intangible assets listed in the asset purchase agreement did not constitute a qualifying cost under TTC § 171.1012(d)(10).²⁸ Thus, the ALJ found the

¹¹ *Id.* *8.

¹² *Id.* *8.

¹³ TTC § 171.101(a).

¹⁴ TTC § 171.1012.

¹⁵ TTC § 171.1012(d)(10).

¹⁶ Texas Comptroller of Public Accounts, Accession No. 201805027H, *10.

¹⁷ *Id.* *10.

¹⁸ *Id.* *10 (citing STAR Document 201412007L).

¹⁹ *Id.* *10 (citing STAR Document 201412007L).

²⁰ *Id.* *10 (citing STAR Document 201412007L).

²¹ *Id.* *10 (citing 2017 Appellate Court decision).

²² *Id.* *10 (citing 2017 Appellate Court decision).

²³ *Id.* *10 (citing 2017 Appellate Court decision).

²⁴ *Id.* *12.

²⁵ *Id.* *11.

²⁶ *Id.* *11.

²⁷ *Id.* *12.

²⁸ *Id.* *11-12.

amounts paid for the franchise rights were properly excluded from the COGS deduction because they were not conveyed by Seller and not included in the intangible assets purchased per the asset purchase agreement.²⁹

Considerations

Taxpayers that purchase a business in which licensing or franchise rights are an element of the acquired business are advised to consult with their tax advisers to determine potential Texas franchise tax implications.

Contacts:

If you have questions regarding the Texas Comptroller's Decision 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

Jacob Aguero
Senior Manager
Deloitte Tax LLP, Houston
+1 713 982 4246
jaguero@deloitte.com

Lauren Rothman
Senior Manager
Deloitte Tax LLP, Houston
+1 713 982 2462
lrothman@deloitte.com

Scott Bedunah
Senior Manager
Deloitte Tax LLP, Dallas
+1 214 840 1722
sbedunah@deloitte.com

Grace Taylor
Manager
Deloitte Tax LLP, Houston
+1 713 982 3809
grtaylor@deloitte.com

For further information, visit our website at www.deloitte.com

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/about to learn more about our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2018 Deloitte Development LLC. All rights reserved.

²⁹ *Id.* *12.