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External Multistate Tax Alert
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Texas Comptroller Decision - Taxpayer Did Not Qualify for Reduced Texas Franchise Tax Rate

Overview

On April 27, 2018, the Texas Comptroller of Public Accounts (Comptroller) released a decision addressing whether a prescription eyeglass distributor (Taxpayer) was eligible for the reduced tax rate reserved for taxable entities primarily engaged in retail or wholesale trade for purposes of the Texas franchise tax (commonly referred to as the Texas margin tax) under Texas Tax Code (TTC) § 171.002(b).

As described in more detail below, the Comptroller ultimately determined Taxpayer's processing activities related to lenses it sold to customers constituted producing or manufacturing a product under TTC § 171.002(c)(2), which disqualified Taxpayer from using the reduced rate.[1]

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

Background

Taxpayer operated as a worldwide distributor of prescription eyeglasses, sunglasses, and other branded merchandise. Taxpayer sold its prescription eyeglasses through its retail optical chains. For report years 2008 and 2009 (collectively, Report Years), Taxpayer and its subsidiaries generally sold finished prescription eyeglasses to its customers, but invoiced the lenses and frames separately based on industry standards.[2] Taxpayer's retail chains often included an onsite laboratory, which allowed Taxpayer to provide frames with prescription lenses to its customers.[3]

Taxpayer purchased all its lens blanks, both finished (i.e., prescription already incorporated into the lens) and semi-finished (i.e., no prescription incorporated into the lens), from unrelated third-party vendors. Taxpayer purchased frames from either foreign affiliates or unrelated third-party vendors.[4] Once ordered by the customer, semi-finished lenses were processed in Taxpayer's lab to incorporate the prescription, and both types of lenses were then prepared to be mounted on a customer's chosen frame.[5]

Prior to filing a report using the reduced rate, Taxpayer formally requested advice from the Franchise Tax Policy Group (Tax Policy) based on its specific facts.[6] In response, Tax Policy issued a private letter ruling (PLR) stating the lens grinding and assembly of glasses at the retail store were considered activities incidental to the sale of eyeglasses and that, because the revenue from the sale of lenses represented the majority of Taxpayer's total revenue, Taxpayer qualified for the reduced rate.[7] The Comptroller subsequently initiated an audit and determined Taxpayer was not eligible for the reduced rate and retracted the previously issued PLR.[8]

Comptroller's interpretation of qualification for reduced rate

Under TTC § 171.002, certain entities primarily engaged in retail or wholesale trade are eligible for a reduced rate.[9] A taxpayer is primarily engaged in retail or wholesale trade if:

1) the total revenue from its activities in retail and wholesale trade is greater than the total revenue from activities in trades other than the retail or wholesale;

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[1] 34 Tex. Admin. Code § 3.584.
[2] Texas Comptroller of Public Accounts, Accession No. 201804024H, SOAH Docket Nos. 304-16-5978.13, 304-16-5979.13, CPA Hearing Nos. 108,321, 108,607 (March 7, 2018), available here.
[3] *Id*. at *6.
[4] *Id*. at *7.
[5] *Id*.
[6] *Id*. at *7-8.
[7] *Id*. at *8.
[8] *Id*.
[9] *Id*. at *9 (citing TTC §§ 171.103(a); 171.002(b)).

2) less than 50% of the total revenue from activities in retail or wholesale trade comes from the sale of products it *produces* or products *produced* by an entity that is part of the affiliated group to which the taxable entity also belongs; and
3) the taxable entity does not provide retail or wholesale utilities, including telecommunications services, electricity, or gas (emphasis added).[10]

The Comptroller's corresponding regulation provides a bright-line rule for establishing if an item a taxpayer sells is considered "produced" by a taxpayer. The rule provides that a product is not considered to be produced if modifications made to the acquired product do not increase its sales price by more than 10 percent (10 Percent Rule).[11] Because Texas statutory law does not define the terms "product" and "produced" for purposes of determining whether a taxpayer qualifies for the reduced rate, the Comptroller has previously determined the words should be given their ordinary meaning.[12] Based on the dictionary definitions of "produce" and "manufacture" (which is used within the definition of the term "produce"), the focus is whether a taxpayer's modifications produce a different product from the product acquired.[13] As part of this inquiry, some physical change to the product is required for the product to be considered sufficiently modified or different for purposes of determining whether a taxpayer qualifies for the reduced rate.[14]

When examining if a taxable entity has the required proportion of revenue generated by retail and non-retail trade, the Comptroller has previously held "if the component part [produced by the taxable entity] is incorporated into 100 percent of the products the taxable entity sells, the taxable entity will not qualify for the [reduced] rate, because all the revenue from the sale of the products produced by the taxable entity will be included in the calculations."[15] Thus, when a component part is produced by the taxable entity and used in all its products, the 10 Percent Rule does not apply because the cost of the item produced is built into the final product the customer is purchasing.[16]

Comptroller decision

Based on the guidance discussed above, the Administrative Law Judge (ALJ) held Taxpayer was not eligible to use the reduced rate because it failed to demonstrate that greater than 50 percent of its revenue from retail sales originated from items not produced by Taxpayer or its affiliates.[17] The processes undertaken by Taxpayer to prepare lenses was found to constitute producing or manufacturing a new final product (i.e., the eyeglasses).[18] The parties had previously stipulated that if the ALJ found the lens processes constituted production or manufacturing of a product, Taxpayer would not qualify for the reduced rate given that essentially all eyeglasses sold would have been "produced."[19] Because at least some preparatory work was done on all lenses, the ALJ found nearly 100 percent of Taxpayer's sales revenue came from products produced by Taxpayer based on the previous stipulation.[20]

Despite this finding, Taxpayer argued the 10 Percent Rule should apply to prevent a finding it had "produced" the eyeglasses because the modifications to the acquired product did not increase its sales price by more than 10 percent. Specifically, Taxpayer argued because the charges for lens processing and work on the frames were not separately billed to the customer, the modifications on the lenses and frames did not increase the invoiced sales price of the lenses or frames. Ultimately, the ALJ ruled that because the modifications made by Taxpayer to the lenses was a component part, which was "incorporated into [or] installed in" the final product sold at retail to the customer, the 10 Percent Rule under 34 Tex. Admin. Code § 3.584(d)(3)(B) did not apply.[21] Further, because the sales price of the eyeglasses included the costs of the

[10] TTC § 171.002(c).
[11] 34 Tex. Admin. Code § 3.584(d)(3)(B).
[12] Texas Comptroller of Public Accounts, Accession No. 201804024H, SOAH Docket Nos. 304-16-5978.13, 304-16-5979.13, CPA Hearing Nos. 108,321, 108,607.
[13] *Id*. at *10.
[14] *Id*. (citing Comptroller's Decision No. 103,871).
[15] *Id*. (citing Comptroller's Decision No. 109,981).
[16] *Id*. at *11.
[17] *Id*.
[18] *Id*. The processes described in the decision as performed by Taxpayer included: grinding (incorporating the prescription into the semi-finished lenses); edging (cutting the lenses to fit the chosen frame); and tracing (aligning the lenses with the frames and with the customer's pupils). *Id*. at *7.
[19] *Id*. at *8, 11.
[20] *Id*. at *11.
[21] *Id*.

processes done in Taxpayer's lab, the modification could not be measured by how much it increased the price. Instead, the work was integral to the production of the final product.[22] As a result, Taxpayer did not qualify for the reduced rate.[23]

Taxpayer also argued detrimental reliance based on the previously issued PLR where Tax Policy had found Taxpayer's lab processes were incidental, and therefore, Taxpayer qualified for the reduced rate.[24] To prove detrimental reliance, a taxpayer must show: 1) the substance of the information or advice and that it followed the information or advice; 2) the taxpayer gave sufficient information to receive correct advice and did not misrepresent information, or withhold or conceal information that would affect the advice; and 3) the taxpayer has suffered, or will suffer, harm based on the erroneous advice unless the Comptroller provides the requested relief.[25] In response to Taxpayer's detrimental reliance argument, the ALJ found the claim failed because Taxpayer did not show it did or would suffer harm based on following the erroneous advice.[26] Specifically, Taxpayer presented no evidence that it would have changed its business plan in relation to the lens processing operation if the Comptroller had determined in the PLR that Taxpayer was not eligible for the reduced rate, and, thus, showed no detrimental reliance.[27]

Considerations

Taxpayers that offer customization, modification, or other processes that may alter the product sold as part of their retail operations are advised to consult with their tax advisers to determine potential Texas franchise tax implications of this Comptroller decision.

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[22] *Id*.
[23] *Id*.
[24] *Id*. at *9.
[25] *Id*. at *12 (citing 34 Texas Admin. Code § 3.10(c)).
[26] *Id*.
[27] *Id*. at *12-13.

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