

January 11, 2008

Mr. Will R. Newton, Executive Director – National Federation of Independent Business  
Mr. Ronnie Volkening, President – Texas Retailers Association  
Mr. Bill Wolters, President – Texas Automobile Dealers Association  
Mr. Tom Blanton, Vice President, Legislative Affairs – Texas Automobile Dealers Association  
1201 Rio Grande St., Suite 100  
Austin, Texas 78701-1751

Gentlemen:

Thank you for your letter concerning the revised franchise tax and, specifically, the issue concerning beginning inventory. The provision concerning beginning inventory was inserted after the public comment period of proposed Rule 3.588(c)(2)(A) in response to a public comment for additional clarity. It is entirely consistent, however, with our process to listen to and consider all industry input at any time, even after the rules become adopted, to evaluate it for consistency with the law.

Immediately after House Bill 3 passed in 2006, we began hearing from various groups that were concerned about the cost of goods sold (COGS) capitalization provisions. Many groups asked if the costs listed could just be expensed, rather than capitalized. However, some start-up companies raised the concern that they may not have revenue the first few years, and they wanted to be able to capitalize. HB 3928 in 2007 was drafted to allow both.

What was not made clear was whether there could be inventory at the beginning of a taxpayer's accounting year for the first report due based on margin. For example, a calendar year taxpayer's 2008 franchise tax report will be based on financial activity for calendar year 2007. Our agency concluded that costs incurred before 2007 for such a taxpayer would not be allowed as a deduction, just as revenue before 2007 would not be included in total revenue.

Consider this example:

Beginning inventory 1/1/2007	\$ 3,000,000,000
Purchases in 2007	12,000,000,000
Ending inventory 12/31/2007	4,000,000,000

Using the example above, on the 2008 franchise tax report we would have allowed a \$12,000,000,000 COGS deduction for taxpayers electing to expense and an \$8,000,000,000 COGS deduction for taxpayers electing to capitalize. Over the life of both companies, however, the deduction for COGS would have been exactly the same; therefore, the establishment of this policy was not driven by revenue forecasts.



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Page Two

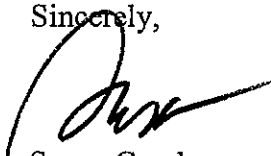
Our primary concern with allowing a beginning inventory for taxpayers electing to capitalize was a potential unequal treatment court challenge brought by taxpayers electing to expense COGS. We were concerned that taxpayers electing to expense COGS would want to take \$15,000,000,000, in the example above, as COGS because we allowed those same costs to be used by those taxpayers electing to capitalize.

After researching all of the relevant court cases in Texas, however, we have decided to allow a beginning inventory for taxpayers electing to capitalize COGS. Our rule will be changed accordingly.

We are available to assist you and your colleagues concerning this tax at any time. If you have any questions, please feel free to contact William Hamner, our director of Tax Administration, by e-mail at [william.hamner@cpa.state.tx.us](mailto:william.hamner@cpa.state.tx.us) or by phone at 475-0545. You may also call me directly at 463-4444.

Please let us know if we can be of any further assistance.

Sincerely,



Susan Combs

cc: William Hamner

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