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CREDITS & INCENTIVES TALK WITH DELOITTE

Research & Development Credits—Texas Considerations

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Research and development (R&D) is an important activity that continues to propel the United States forward into the 21st century. In 2014, it was projected that the United States would invest $465 billion in R&D, relative to the estimated $1.6 trillion invested in R&D globally during the year.[1] The U.S. has continued to be the largest investor in R&D, though the gap has narrowed relative to certain countries such as China.

At the federal level, a nonrefundable income tax credit is available for a company making significant investments in R&D. Approximately 45 states also offer state-level R&D tax credits, including a few states where the R&D credit may be refundable.[2]

The Protecting Americans from Tax Hikes Act (PATH)[3] signed by President Obama on December 18, 2015, made the federal R&D credit permanent. For tax years commencing on or after January 1, 2016, the R&D credit is modified to allow an eligible small business (as defined in section 38(c)(5)(C)) to claim the R&D credit against both its regular tax and alternative minimum tax (AMT) liabilities.[4] Also, for tax years commencing on or after January 1, 2016, certain small businesses may claim the R&D credit against the employer portion of their payroll tax liability, rather than against their income tax liability.[5]

If a primary goal of the federal R&D credit is to encourage companies to conduct R&D activity in the U.S., individual states, hoping to attract companies along with the high-wage, technically skilled jobs associated with the conduct of R&D, are similarly motivated. Competition for companies conducting R&D activity is fierce, and state-level R&D tax credits are one component in a state's economic development plan to encourage companies to consider conducting such activity in the state. In many states, the computation of the R&D tax credit is modelled on the federal credit methodology to avoid the administrative burden on both taxpayers and the state taxing authority that potentially arises from application of an entirely different calculation.

Texas has been aggressive in its support of economic growth through economic development programs such as the Texas Enterprise Zone Program, Renewable Energy Incentives, Skills Development Fund, and the Texas Enterprise Fund. On June 14, 2013, Texas Governor Rick Perry signed House Bill 500 (H.B. 500) and House Bill 800 (H.B. 800) which expanded the incentives available for companies conducting R&D activity in Texas through the creation of an electable sales/use tax exemption or franchise tax credit.

Sales/use tax exemption

The sales/use tax exemption became effective January 1, 2014,[6] and will expire on December 31, 2026.[7] The exemption applies to the sale, storage or use of depreciable tangible personal property directly used in "qualified research" if the property is sold, leased, rented to or stored, or used by a person who is engaged in "qualified research."[8] The exemption is not available if the taxpayer (or a member of the taxpayer's combined Texas franchise tax combined reporting group) claims an R&D credit on its franchise tax return for the period.[9]

Taxpayers must register with the Comptroller's office before claiming the exemption on qualifying purchases.[10] Registration may be performed either by using the Comptroller's online registration system or by filing Form AP-234, Texas Registration for Qualified Research and Development Sales Tax Exemption.[11] Upon completion of the registration, the Comptroller will issue to the taxpayer a Texas Qualified Research Registration Number (Registration Number).[12] Taxpayers must furnish a Texas Qualified Research Sales and Use Tax Exemption Certificate (Form 01-931) to the retailer when claiming the exemption and must file an Annual Information Report with the Comptroller's office on or before March 31 of the year immediately following the calendar year in which they claimed the exemption.[13]

Franchise tax credit

The R&D credit is available on Texas franchise tax returns originally due on or after January 1, 2014, and will expire on December 31, 2026.[14] The amount of the credit is 5% of the difference between:

- The qualified research expenses incurred in Texas during the period on which the report is based; and
- 50% of the average amount of qualified research expenses incurred in Texas during the three tax periods immediately preceding the period on which the report is based.[15]

The tax credit is not available for any qualified research expense incurred in Texas during the period on which a report is based if the taxpayer (or a member of the taxpayer's Texas combined reporting group) claims a sales/use tax exemption under Tex. Tax Code § 151.3182 during that period.

If the taxable entity has no qualified research expenses in Texas in one or more of the three tax periods preceding the period on which the report is based, the credit for the period on which the report is based equals 2.5% of the qualified research expenses incurred in Texas during that period.[16]

The credit is limited to 50% of the amount of franchise tax due before any other applicable tax credits.[17] The credit can be carried forward for 20 consecutive reports.[18] Credits are considered to be used in the following order:

- R&D credit carryforward generated prior to January 1, 2008,
- R&D credit carryforward pursuant to H.B. 800, and
- current year R&D credit.[19]

A taxpayer must apply for the credit on the tax report for the period for which the credit is claimed.[20] The franchise tax R&D credit statute will expire on December 31, 2026, though the expiration will not affect the unused credit carryforwards allowed under Tex. Tax Code §171.659.[21] An R&D credit carryforward cannot be conveyed, assigned or transferred unless all the assets of the taxable entity are conveyed, assigned or transferred in the same transaction.[22]

Conclusion

Companies conducting research and development activities in Texas should consider the availability of the electable R&D sales/use tax exemption or franchise tax credit as well as whether R&D activities conducted in any other state may qualify for an R&D tax credit or other incentive available in that state.

[1] Battele, *2014 Global R&D Funding Forecast*, https://www.battelle.org/docs/tpp/2014_global_rd_funding_forecast.pdf

[2] Deloitte Tax LLP, *2015 Global Survey of R&D Incentives*, October 2015, http://www2.deloitte.com/content/dam/Deloitte/nl/Documents/tax/deloitte-nl-tax-global-survey-r-and-d-incentives-2015.pdf

[3] H.R. 2029, 114th Cong. (2015-2016).

[4] Deloitte, *Tax News & Views*, December 18, 2015.

[5] *Id.*

[6] Acts 2013, 83rd Leg., Reg. Sess., ch. 1266 (H.B. 800) §§ 5, 7.

[7] Tex. Tax Code § 151.3182(f).

[8] Tex. Tax Code § 151.3182(b). The term "qualified research" will have the same meaning as that applicable in I.R.C. § 41.

[9] Tex. Tax Code § 151.3182(b)(2).

[10] *See* Texas Comptroller of Public Accounts, Sales Tax Exemption or Franchise Tax Credit for Qualified Research Effective Jan. 1, 2014.

[11] *Id*.

[12] *Id*.

[13] *Id.*

[14] Acts 2013, 83rd Leg., Reg. Sess., ch. 1266 (H.B. 800) §§ 6, 7.

[15] Tex. Tax Code § 171.654(a). Note that if the taxable entity contracts with one or more public or private institutions of higher education for the performance of qualified research, the credit will be 6.25% of the difference referenced above. Tex. Tax Code § 171.654(b).

[16] Tex. Tax Code § 171.654(c). Likewise, if the taxable entity contracts with one or more public or private institutions of higher education for the performance of qualified research, but has no qualified research

expenses in Texas in one or more of the three tax periods preceding the period on which the report is based, the credit for the period on which the report is based equals 3.125% of all qualified research expenses incurred during that period. Tex. Tax Code § 171.654(d).

[17] Tex. Tax Code § 171.658.

[18] Tex. Tax Code § 171.659.

[19] Tex. Tax Code § 171.659(1)-(3).

[20] Tex. Tax Code § 171.661.

[21] Tex. Tax Code § 171.665.

[22] Tex. Tax Code § 171.660.