



MULTISTATE TAX

Texas Comptroller adopts amended rules for R&D activities

Tax Alert

Overview

The Texas Comptroller of Public Accounts (“Comptroller”) recently filed adopted rule amendments with the Office of the Secretary of State to incorporate numerous changes to the franchise tax research and development (“R&D”) activities credit and the sales/use tax R&D exemption (collectively, “Adopted Rules”), applicable to research activities classified as “qualified research,” as defined by [IRC section 41\(d\)](#). A copy of the Texas Register issue that includes the Adopted Rules is available [here](#) (Franchise Tax) and [here](#) (Limited Sales, Excise, and Use Tax).

As noted in [our previous alert](#), the preamble of the Adopted Rules indicates the amendments reflect the Comptroller’s existing policy. As such, the Comptroller intends to apply the Adopted Rules retroactively to reports due on or after January 1, 2014, as well as prospectively.

This Tax Alert summarizes several key provisions of the Adopted Rules.

New Texas R&D Adopted Rules

Applicability of Federal R&D regulations and determinations

- Federal R&D regulations: Applicable to the Texas R&D credit or exemption only to the extent such federal R&D regulations expressly apply to the 2011 federal tax year. The Adopted Rules specifically reference [Treas. Reg. § 1.174-2](#) (adopted on July 21, 2014 and referred to as the “pilot model” regulations) and [Treas. Reg. § 1.41-4\(c\)\(6\)](#) (adopted on November 3, 2016 and addresses internal use software) as examples of federal regulations that do not apply when determining the Texas R&D credit or exemption.
- Burden of proof: While the federal burden of proof evidence standard for establishing entitlement to the R&D credit is “preponderance of evidence,” the standard for determining entitlement to the Texas R&D credit and exemption, and for valuation of the credit, is set at a higher “clear and convincing evidence” standard.

- Federal audit determinations of eligibility for the R&D credit: Determination by the Internal Revenue Service regarding eligibility for the federal R&D credit under IRC section 41 is not binding on the Comptroller when determining eligibility for the Texas R&D credit or exemption.

Four-Part Test

The Adopted Rules generally follow IRC section 41 and the federal regulations thereunder with a few notable exceptions as follows:

- *Business Component Test*: Designs are not eligible as business components for Texas R&D credit or exemption purposes because designs are not considered to be a product, process, computer software, technique, formula, or invention.
- *Process of Experimentation Test*: The Adopted Rules provide guidance as to the factors to be considered in determining whether a trial and error methodology is “experimental systematic trial and error” (qualified) or “non-experimental simple trial and error” (non-qualified) as follows:
 - (i) Whether the person conducting the trial-and-error methodology stops once a single acceptable result is found or continues to find multiple acceptable results for comparison;
 - (ii) Whether all the results of the trial-and-error methodology are recorded for evaluation;
 - (iii) Whether there is a written procedure for conducting the trial-and-error methodology; and
 - (iv) Whether there is a written procedure for evaluating the results of the trial-and-error methodology.

The Adopted Rules also provide several examples of activities that do and do not qualify as a process of experimentation within specific industries (*e.g.*, construction, oil and gas, and pharmaceutical) for purposes of both the franchise tax credit and sales/use tax exemption.

Various examples related to exclusions

The Adopted Rules provide examples to illustrate whether certain research activities are excluded from the definition of “qualified research” for purposes of the Texas R&D credit and exemption:

- Computer software exclusion: The Adopted Rules added examples of software development activities that are excluded from or included within the definition of “qualified research.”
- Funded research exclusion: An additional requirement was added that a taxable entity performing research for another person must identify any other person paying for the research activities and any person with substantial rights to the results of the research.

Impact of claiming sales/use tax exemption

To the extent a sales/use tax exemption is claimed on the purchase of a taxable item and that exemption is for a use other than use in qualified research (*e.g.*, manufacturing), the item is excluded from being an in-house research expense, even if the expense otherwise qualifies.

Credit carryforwards

Any carryforward of unused R&D credits will be subject to verification by the Comptroller even if the statute of limitations for the year in which the credit

was created has expired. While the verification will not result in an adjustment to tax, penalty, or interest for any report year for which the statute of limitations has expired, it may result in an adjustment to the carryforward for all periods within the unexpired statute of limitations and for all future periods in which the taxable entity may claim the carryforward.

If there is a change in the membership of the Texas combined group, the resulting combined group is a new taxable entity for purposes of the R&D credit, and the resulting combined group is generally not entitled to the carryforward of the credit because it is no longer the same taxable entity as the taxable entity that established the credit carryforward. Several exceptions to the default rule regarding changes to the Texas combined group and impact on the credit are also provided within the Adopted Rules.

Considerations

Taxpayers that historically, currently, or may prospectively claim an R&D credit or exemption in Texas should evaluate the impact of the Adopted Rules for reports due on or after January 1, 2014. Generally, the Comptroller may assess any additional tax due up to four years from the date the tax is due and payable. However, the retroactivity of the Adopted Rules may result in proposed adjustments by the Comptroller for periods beyond the four-year statute of limitations. Moreover, taxpayers should understand that where adjustments to tax due exceed the amount initially reported by 25% or more, the four-year limitations period does not apply. In addition, taxpayers reporting the R&D credit as a carryforward based on historical activities should consider the risk of disallowance in the event of an audit particularly in light of the provision specific to credit carryforwards, as discussed above.

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