



MULTISTATE INCOME/FRANCHISE TAX

Texas Comptroller provides guidance on research and development costs includable in Texas COGS Tax Alert

Overview

The Texas Comptroller of Public Accounts (“Comptroller”) recently issued a ruling discussing the documentation required to demonstrate whether certain costs attributable to research and development (“R&D”) are permitted to be included in cost of goods sold deduction (“COGS”) for Texas franchise tax purposes.¹ This guidance is in the form of a Comptroller decision pursuant to an administrative hearing, which became final on March 1, 2021.

Research and development costs includable in Texas COGS

Background

Taxpayer engaged in the design, manufacture, marketing, sales, and servicing of semiconductor equipment used in the fabrication of integrated circuits. On its original Texas franchise tax return, Taxpayer elected to use the Texas COGS deduction to calculate its taxable margin under Texas Tax Code (“TTC”) § 171.1012. Taxpayer subsequently filed amended franchise tax returns for report years 2012 through 2016 claiming refunds of the tax paid due to credits and additional COGS deductions that were not included on the originally filed returns. On its amended returns, Taxpayer included within the Texas COGS deduction R&D costs reported for federal tax purposes that were considered qualified research expenses under IRC section 174.²

The amended returns were subsequently audited by the Comptroller whereby a portion of the R&D costs were denied, and additional support was requested. As support, Taxpayer provided a listing of the denied accounts and argued the costs at issue should qualify as Texas COGS under TTC § 171.1012(c)(9), which provides a “taxable entity may include in its COGS deduction research, experimental, engineering, and design activity costs, including all research or experimental expenditures described by Section 174 of the IRC, relating to goods it sells” (emphasis added). Following the audit, the Comptroller removed several R&D accounts from Texas COGS based on the auditor’s

uncertainty as to whether the accounts “related to the goods” Taxpayer sold as required under TTC § 171.1012(c)(9).³

Administrative Law Judge decision

The primary issue centred on whether the costs qualified under TTC § 171.1012(c)(9), and, if so, whether those costs related to the goods Taxpayer sold, regardless of whether Taxpayer was the producer of the goods.⁴ As explained by the Administrative Law Judge, the Texas statutory requirement that costs must relate to a product an entity sells “emphasizes the distinction between the COGS deduction and the qualifications for costs under IRC section 174, which applies to expenditures related to products that are sold as well as those that are not sold.”⁵ Taxpayer was required to demonstrate by a preponderance of the evidence that the disputed accounts qualified for inclusion with Texas COGS under TTC § 111.0041. The only evidence provided by Taxpayer related to the disputed accounts was the expense account listing, which failed to demonstrate the costs at issue related to goods Taxpayer sold as “summary schedules and assertions...are insufficient to meet the burden of proof.” As a result, the denial of the refund claims was affirmed.⁶

Observations:

Taxpayers that have historically included all R&D expenses as reported for federal income tax purposes within its Texas COGS deduction should ensure such costs qualify under TTC § 171.1012(c)(9) (e.g., relates to goods taxpayer sold). Taxpayers should also consider whether additional documentation related to its R&D expenses should be retained for Texas COGS purposes based on the Comptroller’s decision concerning acceptable documentation.

Get in touch

[Robert Topp](#)

[Grace Taylor](#)

[Crissy Williams](#)

[Lauren Rothman](#)



Footnotes

¹ STAR Accession No. 202102006H (Feb. 2, 2021), available [here](#).

² *Id.* at *6.

³ *Id.*

⁴ *Id.* at *8.

⁵ *Id.* at *6-7.

⁶ *Id.* at *8.

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30 Rockefeller Plaza
New York, NY 10112-0015
United States

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