Recently, Texas passed a bill providing tax incentives for certain research and development (“R&D”) activities conducted in the state of Texas. The new law, detailed in House Bill 800, offers taxpayers the choice of a Franchise Tax Credit for R&D expenditures or a Sales & Use Tax Exemption on the purchase or lease of depreciable tangible personal property used in qualified research in Texas. The new law also provides an incentive for taxpayers to contract with institutions of higher education to perform qualified research in Texas. The R&D Franchise Tax Credit can be claimed on Texas Form 05-178. The R&D Franchise Tax Credit is effective for reports due on or after January 1, 2014 and the Sales & Use Tax Exemption is effective January 1, 2014. Both incentives are currently set to expire on December 31, 2026.

Franchise Tax Credit

**Eligibility:** In general, taxpayers are eligible for the Franchise Tax Credit if they have Qualified Research Expenses (“QREs”) as defined by IRC §41, in Texas, during the tax period. Taxpayers are ineligible for the Franchise Tax Credit during a tax period if the taxpayer or a member of the taxpayer’s combined group receives the newly created Sales & Use Tax Exemption for purchases or leases of depreciable tangible personal property used in qualified research in Texas. (Sec. 171.653(a)).

**Effective Date:** Taxpayers can begin to take advantage of the Franchise Tax Credit on Texas returns filed on or after January 1, 2014 (i.e., beginning with tax years ended in 2013). Depending on a taxpayer’s year end, QREs incurred in 2012 may also be taken into consideration for the credit. For example, if a taxpayer has a fiscal year end of June 30, 2013, QREs for the taxpayer from July 1, 2012 to June 30, 2013 may be taken into account for the credit.

**Credit Amount:** Similar to the methodology used to calculate the Federal Alternative Simplified Credit, in general, the Texas Franchise Tax Credit is 5% of the difference between the QREs incurred during the tax period (“current period QREs”) and 50% of the average QREs incurred during the prior three tax periods (“base amount”). (Sec. 171.654). Note that an additional benefit exists for contracting with an institution of higher education.

**Credit Limit:** The allowable Franchise Tax Credit in any one tax period, including any carryforward amount, may not exceed 50% of the taxpayer’s franchise tax due for the period. (Sec. 171.658).

**Credit Carryforward:** The amount in excess of the credit limit may be carried forward for a maximum of 20 consecutive tax periods. An outstanding carryforward may be utilized after the December 31, 2026 expiration date. (Sec. 171.659).

Credits cannot be assigned or transferred unless all the assets are transferred in the same transaction. (Sec. 171.660).

If a taxpayer is ineligible for the Franchise Tax Credit due to the fact it elects the Sales & Use Tax Exemption, it will not affect the taxpayer’s eligibility to use carryforward Franchise Tax Credits, not to exceed 50% of the franchise tax due before any other applicable tax credits for the period. (Sec. 171.653).

**No Existing Base Amount:** If a taxpayer has no QREs in one or more of its base years, the credit will be equal to 2.5% (3.125% if contracted with an institution of higher education) of the current period QREs. (Sec. 171.654).

**Institutions of Higher Education:** If a taxpayer contracts with a public or private institution of higher education for the performance of qualified research in the state of Texas, the tax credit increases to 6.25% (1.25% increase) of the difference between the current period QREs and base amount. (Sec. 171.654).

An institution of higher education consists of any public technical institute, public junior college, public senior college or university, medical or dental unit, public state college, or other agency of higher education defined in Texas Education Code Sec. 61.003.

**Combined Groups:** A combined group will be considered one taxable entity. If any member of a combined group elects the Sales & Use Tax Exemption, the election will cause all members of the group to be ineligible for the Franchise Tax Credit. (Sec. 171.656).

**Acquisitions and Transfers of Controlling Interest:** In situations where one company has acquired a controlling interest in another taxable entity or in a separate unit of another taxable entity, QREs will need to be allocated appropriately. (Sec. 171.655).
Acquiring Entity

An entity acquiring a controlling interest in an entity that performs qualified research in Texas may be able to claim a portion of the acquired entity’s QREs. For the year of acquisition, the acquiring company’s QREs equal the amount of QREs incurred by the acquiring taxable entity during the current tax period plus the amount of QREs incurred by the acquired taxable entity or unit during the portion of the current tax period that precedes the date of acquisition. For example, if Company A acquires a controlling interest in Company B on November 30, 2013, and Company A’s fiscal year end is December 31, 2013, then Company A can claim Company B’s QREs from January 1, 2013 to November 30, 2013. However, if the selling entity has elected the Sales & Use Tax Exemption during the period of acquisition, the acquiring company will not be allowed to claim the QREs incurred by the acquired taxable entity.

Selling Entity

The selling entity may not claim the Franchise Tax Credit for QREs incurred by the transferred unit if the selling entity elected the Sales & Use Tax Exemption or if the acquiring taxable entity claimed a credit for the acquired QREs during the current tax period.

However, if at any time during the three tax periods following the period of acquisition, the selling entity reimburses the acquiring entity for QREs incurred by the acquired entity when it was a part of the selling entity, the amount of reimbursement is considered QREs incurred by the selling entity for the period which the reimbursement was paid. Thus, reimbursement will be excluded from the QREs incurred by the acquiring taxable entity for the period in which the reimbursement was paid.

Sales & Use Tax Exemption

- **Eligibility:** In general, taxpayers are eligible for the Sales & Use Tax Exemption if they are engaged in qualified research in Texas and will not be claiming the Texas Franchise Tax Credit.

- **Effective Date:** Unlike the Franchise Tax Credit, benefits from the Sales & Use Tax Exemption will not apply to activities until the effective date. Thus, expenses incurred on or after the effective date of January 1, 2014 are eligible for the Sales & Use Tax Exemption.

- **Qualified Expenses:** Sales tax on the purchase of depreciable tangible personal property (property with a useful life greater than 1 year and can be depreciated according to GAAP, IRC 167, or IRC 168) directly used in qualified research if sold to, rented to, stored by, or used by a taxpayer who is engaged in qualified research and who will not claim the Texas Franchise Tax Credit. (Sec. 151.3182).

- **Combined Groups:** A combined group will be considered one taxable entity. If any member of a combined group elects the Franchise Tax Credit, the election will cause all members of the group to be ineligible for the Sales & Use Tax Exemption.

Franchise Tax Credit vs. Sales & Use Tax Exemption

- **Change in Election:** Initial discussion with taxing authorities indicates that a taxpayer may have the option of changing its benefit election (Franchise Tax Credit or Sales & Use Tax Exemption) during a tax year. Additionally, the election to take advantage of the Franchise Tax Credit vs. the Sales & Use Tax Exemption may be applied retroactively. For example, if a taxpayer initially claims the Sales & Use Tax Exemption and then wants to change to the Franchise Tax Credit, they may be able to pay the exempted sales tax from the current period, subject to penalties and interest on the underpayment of tax. On the other hand, if a taxpayer initially plans on electing the Franchise Tax Credit, but later decides they would prefer the Sales & Use Tax Exemption the taxpayer may apply for a refund for the sales tax paid during the year. It is expected that the Comptroller will further address this issue at a later date.

Why KPMG?

Research and development can be extremely expensive for taxpayers, yet is an essential element for staying competitive in today’s marketplace. Identifying all of the potential tax benefits can be complicated, costly, and time-consuming. Many companies lack the proper expertise to analyze their data in detail, which can lead to misclassified, incomplete, or inconsistent records. The end result may be the loss of tax benefits. This is where KPMG can help. Our Accounting Methods and Credit Services (“AMCS”) professionals have years of experience helping taxpayers take advantage of R&D benefits. In addition, KPMG has access to cross-functional teams with specialized expertise that further assist our clients with complicated tax matters. Organizations potentially benefit from these tax savings with minimal disruption when they work with KPMG’s AMCS professionals. Tangible benefits may include the potential for increased cash flow due to tax savings, mitigation of risk by identifying the proper qualified research expenses, and increased return on R&D investment.

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