



TaxNewsFlash

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Texas: Revised R&D rules for state tax purposes

Taxpayers may claim either a sales tax exemption or a franchise tax credit for qualifying research expenses that occur in Texas.

A revised version of 34 TAC §3.599—addressing the franchise tax research and development (R&D) activities tax credit—and a revised version of 34 TAC §3.340—addressing the R&D sales tax exemption—are scheduled to be published in the Texas Register on October 15, 2021.

KPMG observation

The newly adopted amendments to 34 TAC §3.599 are extensive, include numerous examples, and in certain instances will limit a taxpayer's ability to qualify for credits.

Many interested parties submitted comments on the rules before they were formally adopted; however, the Comptroller declined many of the suggested changes. There is no specific effective date for the proposed rule changes, but the preamble to the rules indicates that the Comptroller views the revisions as being expositions of existing Comptroller policy. As such, the changes will be applied retroactively, as well as prospectively.

Importantly, revised 34 TAC §3.599 addresses the disconnect between federal and state law that exists because Texas has adopted the Internal Revenue Code as of December 31, 2011, for purposes of the R&D activities tax credit. The revised rules clarify that federal regulations adopted after that date are applicable for Texas purposes only to the extent that the federal regulation is made to apply to the 2011 federal tax year.

Summary

Certain key highlights of the revised rule are as follows:

- The rules adopt the federal “four-part test” to determine whether research activities are “qualified research” conducted in Texas.

- The definition of “qualified research expense” is expanded to include lengthy definitions of “in-house research expenses” and “contract research expenses.”
- The new list of **excluded** research activities specifically includes any research with respect to internal-use software, and guidance is provided on certain types of software that are not considered internal-use software.
- The revised rules clarify that the federal regulations (Reg. section 1.174-2) regarding pilot models and prototypes, among other items, are not applicable to the Texas credit.
- A taxpayer cannot claim a manufacturing or resale sales tax exemption for tangible property claimed as a research expense.
- A taxpayer must establish with clear and convincing evidence (that is supported by contemporaneous documentation) that the expenses claimed are eligible for the credit.
- A taxpayer claiming a carryforward of an unused credit must be able to prove the credit was correctly established, even it were established outside of the statute of limitations.

KPMG observation

Certain of these changes attempt to retroactively preclude taxpayers from qualifying for the credit. Litigation has already been filed in a Texas trial court challenging the Comptroller’s policies regarding internal-use software.

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