TEXAS TAXPAYERS
TTARA
AND RESEARCH ASSOCIATION

COST
COUNCIL ON STATE TAXATION

May 15, 2021

Ms. Teresa Bostick
Director, Tax Policy Division
Texas Comptroller of Public Accounts
P.O. Box 13528
Austin, Texas 78711-3528

Re: Proposed Franchise Tax Rule 34 TAC §3.599 and Sales Tax Rule 34 TAC §3.340, as published in the Texas Register on April 16

Dear Director Bostick:

The Texas Taxpayers and Research Association (TTARA) and the Council On State Taxation (COST) jointly offer our comments on the above-referenced rules relating to research and development (R&D). These amended rules will apply to the sales tax exemption (Texas Tax Code 151.3182) and the franchise tax credit (Texas Tax Code 171, Subchapter M) created in HB 800, passed in 2013 and authored by State Representative Murphy, 4 joint-authors and 74 coauthors.

As you recall, TTARA was actively involved in supporting and assisting in the drafting of the legislation. Lawmakers were clear in their stated purposes of the act:

1. Make Texas economically competitive in the field of research and development;
2. Reduce the tax burden on research and development activities in Texas and encourage new investments in this state;
3. Promote the creation of new, highly skilled, high-paying jobs in Texas; and
4. Complement this state 's manufacturing industries by encouraging innovation and efficiency in applying new technologies and producing new products.

The bill has been a success. In 2013, Texas, home to 8.4 percent of the nation's population accounted for only 3.4 percent of the nation's spending on research and development.[1] In 2017, the last year for which data are available, Texas' share had grown to 4.9% — a substantial improvement, though still far below where Texas should be.

We have concerns that the agency's proposed rules will make Texas' incentive narrower and more restrictive that the legislature intended. Texas' R&D provisions will be less attractive than that available in 34 other states. That will harm Texas' ability to compete with other states for R&D investment and hamper the ability of the state to achieve the purposes of the original Act. We believe the state should

[1] National Science Foundation, Science and Engineering State Profiles, Total R&D Performance, selected years.

do nothing to blunt this development, and are concerned that the rules as proposed would severely constrain what the Texas Legislature intended as a generous invitation to businesses to invest in R&D activities in the state.

Our members have brought several questions and concerns we would like to bring to the agency's attention. Because the two proposed rules include very similar language, our comments apply to both rules, unless specifically stated otherwise.

1. **Federal Conformity.** The proposed rules adopt many of the provisions of the federal tax credit under IRC 41 and the associated regulations adopted by the Treasury Department; but then what we would normally consider a positive step turns negative as the state imposes a separate set of standards—all more restrictive—applying them independently of a determination made by the IRS. The rules require taxpayers deemed eligible for the federal credit to prove, with the application of a separate set of standards, that those same expenditures are eligible for the Texas credit/exemption. In each of the cases noted below, the state's deviation from the federal administration of the credit raises the bar for qualifying for the credit in Texas. This is particularly troubling from a policy perspective, as Texas's credit will be diminished not just relative to federal law, but also relative to the research and development incentives available in other states.

   a. 2011 Reference Year. Texas Tax Code §171.651(1) and 151.3182(a)(2) connect the Texas credit to the Internal Revenue Code as it existed on December 31, 2011; however, the proposed rules contravene that by ignoring subsequent federal regulations applying to that federal statutory language if the regulation did not specifically "require" it be applied to the 2011 tax year.[2] The proposed rule would specifically exclude certain federal regulations that a taxpayer was permitted to apply to their 2011 return.[3]

   Tax Code §171.651(1) specifically states that the definition of IRC includes "any regulations adopted under that code *applicable* [emphasis added] to the tax year to which the provisions of the code in effect on that date applied." A federal regulation that gives the taxpayer the option of applying it to their 2011 tax year is indeed applicable to 2011, whether the taxpayer opted to apply it or not. The Comptroller's proposed rule creates a more restrictive standard in conflict with the one in the Tax Code.

   Regardless, other post-2011 regulations apply to the language in the IRC as it existed in 2011, though not retroactively to the 2011 tax return. These federal regulations provide greater clarity for taxpayers, but under the Comptroller's proposed rule Texas disregards them and instead defers to confusion. Taxpayers will have to maintain multiple sets of books based on the same language in law, but with differing regulatory interpretations.

   b. Internal Use Software. The proposed franchise tax rule, 34 TAC §3.599(d)(5) simply denies the franchise tax credit for "Any research activities with respect to internal use software." This

[2] Proposed 34 TAC §3.599((a)(5) adds a new sentence: "A regulation adopted after December 31, 2011 is only included in this term ["Internal Revenue Code"] to the extent that the regulation *requires* [emphasis added] a taxable entity to apply the regulation to the 2011 federal income tax year.
[3] An example of this is Treasury Regulation §1.41-4, adopted October 3, 2016.

conflicts with the 2011 federal code that directly specified that internal use software qualifies provided it meets certain conditions, specifically:

1. The software satisfies the requirements of Section 41(d)(1),
2. The research is not excluded under Section 41(d)(4), and
3. The software satisfies the high threshold of innovation test.[4]

Further, the Treasury Department has since adopted regulations providing guidance by which internal use software can more broadly qualify for the federal credit. Though it was not in effect in 2011, we believe the rules should incorporate these provisions to provide greater conformity with the federal credit and minimize compliance burdens and financial uncertainty with the Texas credit.

c. Standard of Proof. The agency rules place the burden of proof on the taxpayer to establish its entitlement to the credit/exemption by clear and convincing evidence. This evidence standard is unnecessarily higher than the preponderance-of-the-evidence standard required by the IRS, and is not found in Texas statutes, but instead has been adopted by prior regulation of the agency[5]. The higher burden of proof will deter, rather than encourage, research and development investment in Texas. It creates uncertainty, where there is none in other states. Why gamble on a dollar in Texas when you're guaranteed the dollar elsewhere?

d. Supplies Used in Manufacturing. HB 800 was designed to allow taxpayers a choice between a franchise tax credit or a sales tax exemption on research and development expenses. Taxpayers may choose one or the other, but not both. Proposed 34 TAC §3.599 takes this a step beyond to the level of individual transactions. Proposed 34 TAC §3.599(a)(8)(A)(iii) provides that a taxable entity may not include an item as a qualified research expense if it claimed a sales and use tax exemption based on an exempt use. We find no such restriction in either IRC §41 or Tax Code Chapter 171 Subchapter M.

Tax Code Chapter 171.653 provides that a taxable entity may not claim the franchise tax credit if it claimed a sales and use tax exemption under Tax Code 151.3182. No other exemptions are referenced.

Treasury Regulation 1.174-2(a)(1) states:

> *The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174. Costs may be eligible under section 174 if paid or incurred <u>after production begin</u>s* [emphasis added] *but before uncertainty concerning the development or improvement of the product is eliminated.*

Texas ties to the federal credit. The federal credit allows certain costs incurred after production (i.e., manufacturing) begins to be included as an eligible expense. Items purchased for use in manufacturing are exempt under Tax Code 151.318 or 151.3181. Tax Code 171.653 only identifies one sales tax exemption claimed that negates eligibility for the franchise tax credit – Tax Code

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[4] T.D. 9786, effective October 4, 2016.
[5] 34 TAC §1.26(c).

151.3182. Therefore, a taxpayer claiming the franchise tax credit should be able to include certain production costs allowable under 1.174-2(a)(1) regardless of whether a sales tax exemption other than Tax Code 151.3182 is claimed.

e. Recordkeeping. Proposed 34 TAC §3.599(e)(2)(B) and 3.340(b)(6) require contemporaneous business records to support the research credit and the sales and use tax exemption, respectively.

The requirement for contemporaneous business records is often interpreted by agents as precluding other types of records or evidence, such as corroborating evidence or testimony, which are often just as relevant, if not more so, than the contemporaneous business records listed above. Furthermore, the nature of the certain industries may not lend itself to the creation or retention of the type of contemporaneous business records envisioned by the Comptroller. For instance, proposed 34 TAC §3.599(c)(1)(D)(vi)[6] lists four factors to be considered in determining whether a taxpayer is engaged in a trial-and-error methodology that is an experimental systematic trial and error (eligible for the research credit) or non-experimental simple trial and error (not eligible for the research credit); three of the four factors include specific documentation as follows:

- Whether all the results of the trial-and-error methodology are recorded for evaluation,
- Whether there is a written procedure for conducting the trial-and-error methodology, and
- Whether there is a written procedure for evaluating the results of the trial-and-error methodology.[7]

These types of records may not be kept by taxpayers in specific industries. It is challenges such as these that ultimately led the IRS to reject any specific documentation requirement for the research credit under IRC §41.

More specifically, the preamble to the final regulations of which the current Treas. Reg. §1.41-4(d) was a part, notes that the proposed regulations did not contain a specific recordkeeping requirement beyond the requirements set out in IRC §6001 and the corresponding regulations,[8] reflecting Congress' stated desire in 1999 when the federal credit was extended:

> *The conferees also are concerned about unnecessary and costly taxpayer record keeping burdens and reaffirm that eligibility for the credit is not intended to be contingent on meeting unreasonable recordkeeping requirements.* [9]

As a result, the IRS stated in 2001:

> *Treasury and the IRS have re-evaluated whether a research credit-specific documentation requirement is warranted and have concluded that the high degree of variability in the objectives and conduct of research activities in the United States compels a conclusion that taxpayers must be provided reasonable flexibility in the manner in which they substantiate*

[6] See proposed 34 TAC §3.340(c)(1)(D)(vi)(II) – (IV) for similar provisions applicable to the SUT exemption.
[7] Proposed 34 TAC §3.599(c)(1)(D)(vi)(II) – (IV).
[8] 69 Fed. Reg. 22 at 24 (2004).
[9] *Id.*

> *their research credits. Accordingly, Treasury and the IRS have concluded that the failure to keep records in a particular manner (so long as such records are in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit) cannot serve as a basis for denying the credit. Treasury and the IRS have decided that the rules generally applicable under section 6001 provide sufficient detail about required documentary substantiation for purposes of the research credit. Consequently, no separate research credit-specific documentation requirement is included in these proposed regulations.*[10]

Thus, records kept in the ordinary course of the taxpayer's business which otherwise meet the general recordkeeping requirements of the Internal Revenue Code suffices for federal research credit purposes. For Texas to impose recordkeeping requirements more extensive than that of the IRS specifically deviates from the very federal law and regulations Texas has adopted by reference.

2. Combined Reporting of Franchise Tax Credit (Tax Code Chapter 171). We believe that requiring each member of a combined group to calculate the research and development credit separately must be made by statute and not by the agency's rule.

Tax Code §171.002(a) first defines a taxable entity to include a combined group. Tax Code §171.656 provides that "[a] credit under this subchapter for qualified research expenses incurred by a member of a combined group must be claimed on the combined report required by Tax Code §171.1014 for the group, and *the combined group is the taxable entity for purposes* of this subchapter [emphasis added]." However, proposed 34 TAC §3.599(i)(5) requires each member of the combined group to calculate the credit separately by changing the definition of taxable entity to mean a separate group member. This change is inconsistent with the statute.

Furthermore, proposed 34 TAC §3.599(i)(4) changes the research and development credit calculation by requiring that the higher education rate applied for contracting with a higher education institution for qualified research be applied separately to each entity within the combined group and not to the combined group as a whole. This change is only possible by changing the definition of a taxable entity to mean an individual member of the consolidated group. Thus, we believe that changes in proposed 34 TAC §3.599(i)(4) and (5) should be excluded and addressed by statute.

Further, this particular change in policy directly reduces the amount of the credit taxpayers have claimed. It will indeed have a very direct fiscal impact on taxpayers by reducing the amount of the credit, though the agency preamble to proposed 34 TAC §3.599 states:

> *The proposed amendment would have no significant fiscal impact on the state government, units of local government, or individuals. There would be no significant anticipated economic costs to the public.*

[10] 66 F.R. 66362, 66366 (December 26, 2001) (Emphasis added). The proposed regulations were finalized on January 2, 2004, T.D. 9104, 69 F.R. 22 (January 2, 2004), with no changes made to the elimination of the recordkeeping requirement.

3. **Design**. Proposed 34 TAC §3.599(c)(1)(C)(ii) and 3.340(c)(1)(C)(ii) would create the following limitation with respect to the Business Component Test (an element of the Four-Part Test required for satisfying the definition of Qualified Research):

    (ii) A design is not a business component because a design is not a product, process, computer software, technique, formula, or invention. While uncertainty as to the appropriate design of a business component is a qualifying uncertainty for the Section 174 Test and the Discovering Technological information test, the design itself is not a business component. For example, the design of a structure is not a business component, although the structure itself may be a business component. Similarly, a blueprint or other plan used to construct a structure that embodies a design is not a business component.

    As an initial matter, a design can certainly be a product, requiring significant research and experimentation. For instance, engineers often develop innovative design concepts and solutions which are embodied in design documents that comprise the design deliverables contracted for by clients. Such design deliverables comport with the common definition of a product which is "something produced," "something (such as a service) that is marketed or sold as a commodity."[11] Further, not all designs—whether created by a taxpayer for use in its business or contracted for by another—translate into physical structures, yet if qualified research was undertaken to develop them, a taxpayer should not be any less eligible to claim a research credit or the SUT exemption simply because the object of the design was either ultimately not constructed or was for something not tangible. Such a result would be wholly inconsistent with the purpose of the research credit/SUT exemption.

    Moreover, there is no exclusion of design from the definition of a business component under IRC §41 or the regulations thereunder. As such, the proposed amendment is inconsistent with the plain meaning of the Texas Tax Code which provides that both "qualified research" and "qualified research expenses" have the meaning assigned by IRC §41.[12] For these reasons, design should not be excluded from eligibility as a business component.

4. **Examples.** We appreciate the Comptroller providing a number of examples in both rules of how a taxpayer may or may not qualify for the credit/exemption; however, the examples of a denial of eligibility are twice the number of examples with an affirmative result. Additional examples of an affirmative result would be beneficial in providing greater clarity.

    In particular, the rules offer examples of activities performed by oil and gas operators that are not included in the federal regulations applicable to the research and development credit and that do not qualify [proposed 34 TAC §3.599(c)(1)(D)(VII) and (VIII), herein referred to as Example 7 and Example 8]. The proposed rules explain that each of these examples fails the Four-Part Test because the activities do not constitute a process of experimentation.

    The hypothetical facts provided in Example 7 ignore the many other technical uncertainties that must be overcome in order to design a successful drilling operation. Selecting technology, even

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[11] https://www.merriam-webster.com/dictionary/product
[12] Tex. Tax Code §171.651(4) and 151.3182(a)(3).

from commercially available options, is only one aspect of the development process required to achieve a successful system design. As the Comptroller correctly acknowledges in the proposed rules, a taxpayer "may undertake a process of experimentation if there is no uncertainty concerning the taxable entity's capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxable entity's research activities."[13] Moreover, consistent with the federal regulations, the Comptroller also acknowledges that taxpayers may "employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science."[14] Accordingly, we believe the agency should reconsider Example 7.

Example 8 is similarly misleading as it also fails to acknowledge the complexities of designing a successful drilling operation and further, that technical uncertainties can—and often do—exist, even when certain elements of the system design are known. Moreover, to the extent Example 8 stands for the proposition that the Process of Experimentation Test can be met only if more than one alternative is evaluated, it is clearly erroneous. Under both the federal regulations and the Comptroller's proposed regulations, the Process of Experimentation Test may be met even if only one alternative is evaluated. Specifically, Treasury Regulation §1.41-4(a)(5)(i) provides as follows:

> *[A] process of experimentation is a process designed to evaluate **one or more** alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. [*emphasis added*].*

The Comptroller's proposed regulations are in line with the federal regulations in that it requires only that the process of experimentation *generally* be *capable* of evaluating more than one alternative; there is no requirement that more than one alternative, in fact, be evaluated. The language in the Comptroller's proposed regulations is as follows:

> *(ii) A process of experimentation must:*
>
> *(I) be an evaluative process and generally should be capable of evaluating more than one alternative….*[15]

For these reasons, the agency should also reconsider Example 8.

We have similar concerns with a third example. Similar to Treas. Reg. §1.41 -4(c)(3), proposed 34 TAC §3.599(d)(2) provides that an activity will not be excluded merely because the business component is intended for a specific customer. The application of this rule is illustrated in a series of examples, including an example of activities performed by an oil and gas operator in proposed 34 TAC §3.599(d)(2)(F). In this example, the oil and gas operator's drilling activities are "excluded from the definition of qualified research because the activities consisted of adapting an existing business component (its existing horizontal drilling process) to meet a particular customer's need." As written, we believe the oil and gas operator's activities are denied merely because they were

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[13] Proposed 34 TAC §3.599(c)(1)(D)(iii); and proposed 34 TAC §3.340(c)(1)(D)(iii).
[14] Proposed 34 TAC §3.599(c)(1)(B)(ii); and proposed 34 TAC §3.340(c)(1)(B)(ii).
[15] Proposed 34 TAC §3.599(c)(1)(D)(ii)(I); and proposed 34 TAC §3.340(c)(1)(D)(ii)(I).

performed for a specific customer. Even if economic results are considered, improving a process for improved performance or reliability is a qualified purpose under the process of experimentation test. In the interest of clarity, we would ask the agency to update the example to clearly illustrate why the oil and gas operator's activities should be excluded and that another example be added illustrating an oil and gas operation that qualifies for the credit even though it was intended for a specific customer.

In the interest of clarity, we would request that the Comptroller add examples illustrating an oil and gas operation that it would determine does meet the Four-Part Test in situations where the activities are not considered commercially available options, as well as where the taxable entity's activities are evaluating alternative methods.

Finally, many of the examples appear to be derived from IRS Audit Guidelines from the early 2000s. A major concern for today's business environment is that the technological references in the guide—and in the rules—do not address today's technology, like cellular phone technology, blockchain, web-based services or cloud computing that often are a central focus of today's R&D activities for many firms. It would provide greater clarity if affirmative examples could be included for more advanced technologies.

5. **Retroactivity**. Prior to these proposed rules, many taxpayers claiming a Texas R&D credit or the sales and use tax exemption did so on the belief that the federal regulations applicable to the research credit under IRC §41 applied with equal force to the Texas incentives. The proposed rules contain numerous substantive provisions we have noted above, that not only diverge from that of IRC §41 and the federal regulations, they consistently act to raise the bar of eligibility for the Texas credit/exemption. Accordingly, applying these rules retroactively by seven years to 2014 is fundamentally unfair. Further, it may do immediate and direct harm to companies that may have to amend previously-filed financial statements, and should be avoided.

We appreciate the opportunity to offer these comments on behalf of TTARA and our members, and are always available at your convenience to discuss further.

Sincerely,

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Texas Taxpayers and Research Association

Patrick Reynolds
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