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Tax Policy

The Research and Development tax credit in Texas, which took effect Jan. 1, 2014, provides companies the option of selecting either a sales tax exemption on property purchased by persons engaged in qualified research activities or the franchise tax credit, but not both. Giles B. Sutton, a partner with McGuireWoods LLP in Washington, D.C. offers a primer on the technical nuances of this new incentive.

New Texas R&D Credit Offers Sales or Franchise Tax Breaks But Not Both: An Examination of Requirements and Benefits



BY GILES B. SUTTON

Introduction

In June of 2013, Texas Governor Rick Perry signed H.B. 800 which provides a sales tax exemption for certain depreciable tangible property used in qualified research or, alternatively, a research and development credit which can offset a portion of a taxpayer's tax due under the Revised Texas Franchise Tax (the Margin Tax) for certain qualified research expenses.

Giles B. Sutton is a partner in the Business Tax Practice of McGuireWoods LLP in Washington, D.C. He can be reached at gsutton@mcguirewoods.com.

The provisions of H.B. 800 took effect Jan. 1, 2014. This article explores the technical nuances of these important Texas tax provisions.

Sales Tax Exemption for Property Used In Research and Development Activities

In general, Subchapter H, Chapter 151 of the Texas Tax Code was amended to add §151.3182. Section 151.3182 provides that the sale, storage or use of depreciable tangible property is exempt from sales tax if used by a person (entity) who is:

- (1) engaged in qualified research; and
- (2) will not claim a credit against the franchise tax for such expenditures.²

² Tex. Tax Code Ann. §151.3182(b).

For purposes of this provision, “depreciable tangible personal property” means tangible personal property with a useful life that exceeds one year and is subject to depreciation under generally accepted accounting principles or Internal Revenue Code (“I.R.C.”) §§167 or 168.³ “Qualified Research” has the meaning assigned by I.R.C. §41.⁴

Taxpayers who receive an exemption will also be required to complete a form to provide information to the Texas Comptroller of Public Accounts in order for the Comptroller to make an evaluation of the effect of the exemption in encouraging research and development in Texas and measuring related economic impacts.⁵

Franchise Tax Credit for Research and Development

House bill 800 also amended the Texas Tax Code to add §§171.651-665 which provides a research and development credit which can offset, in part, a taxpayer’s liabilities under the margin tax. However, taxpayers who claim a sales tax exemption under Tex. Tax Code Ann. §151.3182 for property used in research and development cannot claim a Margins Tax credit for the same period.⁶

In general, a taxpayer’s credit for certain research and development for any report year will equal 5 percent of the difference between:

(1) the qualified research expenses within Texas⁷ incurred during the period on which the report is based; and

³ Tex. Tax Code Ann. §151.3182(a) (1). For purposes of this provision the I.R.C. means the Internal Revenue Code of 1986 in effect on Dec. 31, 2011, excluding any changes made by federal law after that date, but including any regulations adopted under that code applicable to the tax year to which the provisions of the code in effect on that date applied. Tex. Tax Code Ann. §171.651(1).

⁴ In general, under the I.R.C., “qualified research” means research which could be expensed under I.R.C. §174, and which is undertaken to discover information which is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer and substantially all of the activities of which relate to a process of experimentation for a new improved function, performance or reliability or quality. I.R.C. §41(d)(1) and (3). However, for purposes of this section, “qualified research” must be conducted in the state of Texas. Tex. Tax Code Ann. §171.651(3).

⁵ Tex. Tax Code Ann. §151.3182(c)(2) and (d). Section 1 of H.B. No. 800 Legislative Findings and Purpose.

⁶ Tex. Tax Code Ann. §171.653(a). Note, that even if a taxpayer is ineligible to claim a credit for margin tax purposes because it claims a sales tax exemption for that period, that will not prevent the taxpayer from utilizing a research and development credit carryforward in that period. Tex. Tax Code Ann. §171.653(b).

⁷ “Qualified research expenses” has the meaning assigned by I.R.C. §41 except the expenses must be incurred in Texas. Tex. Tax Code Ann. §171.651(4). Under I.R.C. §41 “qualified research expenses” are the sum of the following amounts paid by the taxpayer in carrying out a trade or business: in-house research expenses; and contract research expenses. I.R.C. §41(b)(1). In-house research expenses are defined under I.R.C. §41(b)(2) and contract research expenses are defined under I.R.C. §41(b)(3).

(2) 50 percent of the average amount of qualified research expenses incurred during the three tax periods preceding the period on which the report is based.⁸

Example:

In report year 2014 the taxpayer incurs \$40 million in qualified research and development expenditures in Texas. The taxpayer has \$10 million in qualified expenditures in 2011, \$20 million in 2012, \$25 million in 2013. Its average expenditures in the prior three years is \$18,333,333. Fifty percent of that average is \$9,166,667. The difference between the current year expenditures, \$40 million, and 50 percent of the prior three years average qualified expenditures, \$9,166,667, is \$30,833,333. Five percent of that difference is \$1,541,667, which is the Texas research and development credit generated in that year.

If a taxpayer has no qualified research expenses in one or more of the three tax periods preceding the period on which the report is based, the credit for the period on which the report is based will equal 2.5 percent of the qualified research expenses incurred during that period.⁹

For taxpayers that contract with institutions of higher education to perform qualified research and for periods in which the taxpayer has research expenditures within Texas pursuant to such contract, the credit for such expenditures will equal 6.25 percent of the difference between:

(1) all the qualified research expenses incurred during the period of the report; and
(2) 50 percent of the average amount of all qualified research expenses incurred during the three tax periods preceding the report year.¹⁰

Attribution of Expenses Following The Transfer of Controlling Interests

If a taxable entity acquires a controlling interest in another taxable entity or in a separate unit of another taxable entity during a tax period during which the acquiring entity claims a research and development credit, the amount of the acquiring taxable entity’s qualified research expenses will equal the sum of:

- the amount of qualified research expenses incurred by the acquiring taxable entity during the period on which the report is based; and
- the amount of qualified research expenses incurred by the acquired taxable entity or unit during the portion of the period on which the report is based that precedes the date of acquisition.¹¹

⁸ Tex. Tax Code Ann. §171.654(a).

⁹ Tex. Tax Code Ann. §171.654(c).

¹⁰ Tex. Tax Code Ann. §171.654(b). If a taxpayer contracts with an institution of higher education for the performance of qualified research but has no qualified research expenses in one or more of the previous three tax periods preceding, the credit for the period on which the report is based will equal 3.125 percent of all qualified research expenses incurred during that period. Tex. Tax Code Ann. §171.654(d).

¹¹ Tex. Tax Code Ann. §171.655(a)(1) and (2). This provision, in essence, provides that for the report period of acquisition, **the acquiring taxable entity** will generally receive the benefit of **the acquired taxable entity or business unit’s** qualified research expenses for the entire report period, **both before and**

Note, an acquiring taxable entity may not include in a report the amount of qualified research expenses of the acquired taxable entity or unit if the taxable entity that made the sale of or other transfer of the taxable entity or unit claimed a sales tax exemption under Tex. Tax Code Ann. §151.3182 during the portion of the period on which the acquiring taxable entity is based that precedes the date of acquisition.¹² Further, a taxable entity that sells or otherwise transfers a controlling interest in a taxable entity or separate business unit or a taxable entity during a period on which a report is based may not claim a credit for qualified research expenses incurred by the transferred taxable entity or business unit during the period if the transferring taxable entity claims a sales tax exemption under Tex. Tax Code Ann. §151.3182, or if the acquiring taxable entity claims a Texas research and development credit for the same period.¹³ This rule essentially prevents “double dipping” by multiple taxpayers for a credit based on the same expenditures.

If during any of the three tax periods following the tax period in which the sale or other transfer of the controlling interest of a taxable entity or business unit occurs, the taxable entity that sold or transferred the controlling interest reimburses the acquiring taxable entity for research activities conducted on behalf of the taxable entity that made the sale or other transfer, the amount of the reimbursement is:

- included as qualified research expenses incurred by the taxable entity that made the sale or other transfer for the tax period during which the reimbursement was paid;¹⁴ and
- excluded from the qualified research expenses incurred by the acquiring taxable entity for the tax period during which the reimbursement was made.¹⁵

Combined Reporting

The credit for qualified research expenditures incurred by a member of a combined group must be claimed on a combined report¹⁶ and the combined group is deemed to be the taxable entity for purposes of the credit.¹⁷

For tiered flow-through entities, an upper-tier entity that includes the total revenue of a lower tier entity for purposes of computing its taxable margin may claim the credit for qualified research expenditures incurred by lower-tier entities to the extent of the upper-tier entity's ownership interest in the lower-tier entity.¹⁸

after the acquisition date. While the combined group is deemed to be the taxable entity for purposes of the research credit (Tex. Tax Code Ann. §171.656(a)) the research expenses belong to a particular business unit or taxable entity. Thus, when such entity or business unit is sold, all of its research expenditures for the period of transfer go with it.

¹² Tex. Tax Code Ann. §171.655(d).

¹³ Tex. Tax Code Ann. §171.655(b).

¹⁴ A taxable entity that makes a sale or other transfer of a taxable entity may not include in a report the amount of the reimbursement if the reimbursement is for research activities that occurred during a tax period during which that taxable entity received a sales tax exemption under Tex. Tax Code Ann. §151.3181. Tex. Tax Code Ann. §171.655(e).

¹⁵ Tex. Tax Code Ann. §171.655(c)(1) and (2).

¹⁶ As required by Tex. Tax Code Ann. §171.1014.

¹⁷ Tex. Tax Code Ann. §171.656.(a).

¹⁸ Tex. Tax Code Ann. §171.656(b).

Burden of Proof

The burden of establishing entitlement to, and the value of the credit, is on the taxable entity claiming the credit.¹⁹

Limitations

The total research and development credit claimed for a given report, including the amount of any carry-forward of the credit, may not exceed 50 percent of the amount of franchise tax due for the report before any other applicable tax credits.²⁰

Credit Carryforward Rules

If a taxpayer qualifies for a credit that exceeds the 50 percent limitation of franchise tax due for any given year (discussed above), the taxable entity may carry the unused credit forward for not more than 20 consecutive reports.²¹ Credits, including carryforwards, are to be used in the following order:

- a credit carryforward of unused credits accrued under Subchapter O before its repeal in Jan. 1, 2008;²²
- a credit carryforward under the current Texas research and development credit regime; and
- a current year credit.²³

Assignment of Credits

A taxable entity may not convey, assign or transfer the Texas research and development credit to another entity unless all of the assets of the taxable entity are conveyed, assigned or transferred in the same transaction.²⁴

Application for the Credit

A taxable entity must apply for a Texas research and development credit on or with the tax report for the period for which the credit is claimed.²⁵ Therefore, just incurring qualified expenses without properly filing the forms with its Texas report in the year the qualified expenses are incurred is insufficient to allow a taxable entity to claim the credit. The report that must be filed by a taxpayer seeking to claim a research and development credit under the RTFT is Form 05-178 Texas Franchise Tax Research and Development Activities Credit Schedule. This schedule must be completed in each year in which qualified research expenses in Texas are incurred for which a credit is sought.

Conclusion

The Texas margin tax is regressive in nature because it taxes businesses based on their respective margins

¹⁹ Tex. Tax Code Ann. §171.657.

²⁰ Tex. Tax Code Ann. §171.658.

²¹ Tex. Tax Code Ann. §171.659.

²² Although the research and development credit established under the previous Texas franchise tax regime was repealed with the enactment of the RTFT, credits established or prior franchise tax reports may be claimed on franchise tax reports with the same carryforward periods as established under the prior franchise tax. Tex. Tax Code Ann. §171.111.

²³ Tex. Tax Code Ann. §171.659(1), (2), and (3).

²⁴ Tex. Tax Code Ann. §171.660.

²⁵ Tex. Tax Code Ann. §171.661.

regardless of their profitability. But these new research and development incentives, the sales tax exemption or the franchise tax credit, are important potential benefits to taxpayers. While the rules are particular in their definitions and mechanics, the carryforward period is gen-

erous. Accordingly, many taxpayers with significant operations in Texas may well benefit from these provisions. Therefore being conversant with these provisions may prove to be important to those taxpayers that have significant Texas tax liabilities.