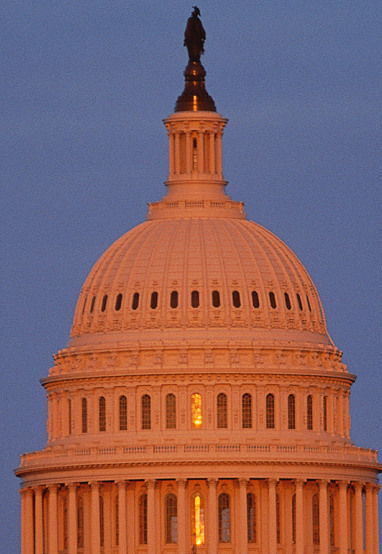




TaxNewsFlash

United States



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Texas: Proposed changes to R&D regulations address federal conformity; combined group changes

The Texas Comptroller of Public Accounts on June 10, 2022, published proposed changes to 34 TAC §3.599 to address the franchise tax research and development (R&D) activities tax credit.

Under Texas law, taxpayers may claim either a sales tax exemption or a franchise tax credit for qualifying research expenses that occur in Texas.

KPMG observation

The Comptroller in 2021 finalized extensive amendments to 34 TAC §3.599 that, in many instances, limited a taxpayer's ability to qualify for credits. The most recent proposed changes are viewed as being more taxpayer favorable.

Application of federal regulations

The proposed amendments address the disconnect between federal and state law that exists because Texas defines the Internal Revenue Code (IRC) for purposes of R&D activities tax credit as the IRC in effect on December 31, 2011. Currently, federal regulations adopted after December 31, 2011, are included in the definition of the IRC only to the extent that the federal regulation is **made to apply to the 2011 federal tax year**.

Under the proposed revisions, a federal regulation adopted after December 31, 2011, would be applicable if a taxable entity could have applied the regulation to the 2011 tax year. In other words, regulations that were not finalized in 2011 may be applied if Treasury allowed the taxpayer to apply the regulation to the 2011 tax year. Newly added examples of regulations that would be included in the definition of IRC are Treasury Reg. sections 1.174-2 and 1.41-4, except for paragraph (c)(6) addressing internal use software. Taxable entities would be able to elect to follow two different versions of paragraph (c)(6).

Credit carryforwards and combined group changes

The proposed changes also address credit carryforwards when a combined group changes. Under the current version of 34 TAC §3.599, generally, if there is a change in membership of the combined group, the resulting

combined group would not be entitled to a credit carryforward. However, there are certain instances, such as when two members merge, that would not be considered changes in membership of a combined group.

Under the proposed amendments, the credit carryforward attributable to a member of a combined group for each prior report year would be determined by multiplying the total credit carryforward available for that report year by a fraction, the numerator of which is the qualified research expenses paid or incurred by the member during that report year, and the denominator of which is the total qualified research expenses paid or incurred by the combined group during that report year.

When the membership of a combined group changes, the credit carryforward would be determined under the regulation as follows.

- If a combined group loses a member, the credit carryforward would be attributed to each member of the combined group that was included on the report for the report year to which the carryforward relates. Each member of the combined group that has a carryforward attributed to it, including the member that leaves the combined group, could continue to use that carryforward on its future franchise tax reports.
- If a taxable entity that was not part of a combined group when it created a credit carryforward later joins a combined group, any credit carryforward it had previously established could be claimed on the combined group's future franchise tax reports.
- If a taxable entity, including a member of a combined group, is a non-surviving entity in a merger transaction, any credit carryforward established by the non-surviving entity could be claimed on the surviving entity's future franchise tax reports.

Unless the above statement applies, if a taxable entity—including a member of a combined group—is terminated, dissolved, or otherwise loses its status as a legal entity, the credit carryforward attributable to that taxable entity could not be claimed on any future franchise tax report.

Generally, a combined group could only use a credit carryforward attributable to a member under these new provisions if that member were part of the combined group on the last day of the accounting period on which that report is based.

Next steps

The proposed changes are expected to apply retroactively, as well as prospectively. There is a 30-day comment period; as such, the earliest possible date of adoption is July 10, 2022.

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