TAX SECTION
State Bar of Texas

November 9, 2020

Via Email to Teresa.Bostick@cpa.texas.gov

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

RE: ***Comments on Draft Proposed 34 Tex. Admin. Code § 3.340, concerning Qualified Research, and Draft Proposed § 3.599, concerning Margin: Research and Development Activities Credit***

Dear Ms. Bostick:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to draft proposed 34 Tex. Admin. Code § 3.340 (Qualified Research) and draft proposed 34 Tex. Admin. Code § 3.599 (Margin: Research and Development Activities Credit) (the "Draft Proposed Rules").

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY

SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Texas Comptroller of Public Accounts for the time and thought that has been put into preparing the Draft Proposed Rules, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Lora G. Davis, Chair
State Bar of Texas, Tax Section

Enclosure

COMMENTS ON DRAFT PROPOSED 34 TEX. ADMIN. CODE § 3.340
AND DRAFT PROPOSED 34 TEX. ADMIN. CODE § 3.599

These comments on the Draft Proposed Rules ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Stephen Long and Matt Hunsaker, Co-Chairs of the State and Local Tax ("SALT") Committee of the Tax Section of the State Bar of Texas, and William J. LeDoux, Vice-Chair of the SALT Committee. The Committee on Government Submissions of the Tax Section has approved these Comments. Ira Lipstet, member of the SALT Committee, also reviewed the Comments and provided substantive suggestions.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: November 9, 2020

I. INTRODUCTION

These Comments are in response to the request of the Texas Comptroller of Public Accounts (the "Comptroller") for comments pertaining to draft proposed 34 Tex. Admin. Code § 3.340, concerning Qualified Research, and draft proposed 34 Tex. Admin. Code § 3.599, concerning Margin: Research and Development Activities Credit.

We recognize and appreciate the time and thoughtful work invested by the Comptroller in preparing the Draft Proposed Rules. We also appreciate the efforts of the Comptroller to survey existing authority and to update existing rules. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may support Comptroller personnel in this endeavor.

II. COMMENTS REGARDING DRAFT PROPOSED RULES

For the reasons set forth herein, we respectfully request that the Comptroller consider revising the text of the Draft Proposed Rules in certain key respects. Most notably, we respectfully suggest that taxpayers should be permitted to exercise regulatory elections set forth in treasury regulations,[1] where applicable, when calculating their Texas research and development credits under Subchapter M of Chapter 171 of the Texas Tax Code (the "Texas R&D Credit") or their Texas sales tax exemption under Subchapter H of Chapter 151 of the Texas Tax Code ("Texas R&D Exemption"). Specifically, certain revisions we propose herein would allow taxpayers to claim a Texas R&D Credit or a Texas R&D Exemption for certain costs related to the development of qualifying internal use software; we also respectfully suggest that the Comptroller consider updating the definition of "internal use software" to resolve ambiguity by reflecting current business practices.

A. Taxpayers Should Be Permitted to Exercise Regulatory Elections When Applicable

The key terms and definitions used to define research activities for both the Texas R&D Credit and the Texas R&D Exemption come from Internal Revenue Code § 41 ("IRC § 41") and the regulations promulgated under that section. *See* Texas Tax Code §§ 151.3182(a)(2) and 171.651(1). For these purposes, the Texas Legislature defined "Internal Revenue Code" as:

> [T]he Internal Revenue Code of 1986 in effect on December 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.

Texas Tax Code §§ 151.3182(a)(2) and 171.651(1).

[1] All references to "treasury regulation" or to "Treas. Reg." shall be to the regulations promulgated under the Internal Revenue Code of 1986, as amended.

In other words, the Legislature has instructed that the version of IRC § 41 that existed on December 31, 2011, and the treasury regulations applicable to such version of IRC § 41—even if adopted after December 31, 2011—should apply for Texas franchise tax and sales tax purposes.

However, the Draft Proposed Rules would permit taxpayers to follow a treasury regulation adopted after December 31, 2011, only if "the regulation *requires* a taxable entity to apply the regulation to the 2011 federal income tax year." (Emphasis added.) Further, the Draft Proposed Rules would add §§ 3.340(d)(5) and 3.599(d)(5), which would explicitly exclude from the definition of qualifying activities "[a]ny research activities with respect to internal use software," presumably because the treasury regulation confirming that taxpayers may claim credits with respect to the costs of internal use software for federal tax purposes was not promulgated until 2016. We respectfully note that Texas Tax Code §§ 151.3182(a)(2) and 171.651(1) do not appear to support either such limitation. Contrary to Texas statutes, the Draft Proposed Regulations would exclude from the definition of "Internal Revenue Code" a treasury regulation that is clearly applicable to the Internal Revenue Code in effect on December 31, 2011, even if such treasury regulations are optional in nature.

Many treasury regulations give taxpayers the *option*, but do not *require* taxpayers, to apply such regulations on a retroactive basis. Treasury regulation § 1.41-4, adopted October 3, 2016 (the "2016 Regulation"), includes such an election, which is critically important in the context of calculating the federal research and development credit under IRC § 41. Treas. Reg. § 1.41-4(e) specifically states as follows:

> **(e) Effective/applicability dates.** Other than paragraph (c)(6) of this section, this section is applicable for taxable years ending on or after December 31, 2003. Paragraph (c)(6) of this section is applicable for taxable years beginning on or after October 4, 2016. For any taxable year that both ends on or after January 20, 2015 and begins before October 4, 2016, the IRS will not challenge return positions consistent with all of paragraph (c)(6) of this section or all of paragraph (c)(6) of this section as contained in the Internal Revenue Bulletin (IRB) 2015-5 (see www.irs.gov/pub/irs-irbs/irb15-05.pdf). *For taxable years ending before January 20, 2015, taxpayers may choose to follow either all of § 1.41-4(c)(6) as contained in 26 CFR part 1 (revised as of April 1, 2003) and IRB 2001-5 (see www.irs.gov/pub/irs-irbs/irb01-05.pdf) or all of § 1.41-4(c)(6) as contained in IRB 2002-4 (see www.irs.gov/pub/irs-irbs/irb02-04.pdf).*

(Emphasis added.)

In other words, the 2016 Regulation, other than the section pertaining to internal use software, applies to all taxable years ending on or after December 31, 2003, including taxable years ending on December 31, 2011. However, with respect to internal use software, the 2016 Regulation permits taxpayers to include certain costs related to the development of internal use software in the calculation of the IRC § 41 credit, provided the taxpayer elects and is able to satisfy certain requirements. Specifically, the 2016 Regulation provides that for taxable years ending

before January 20, 2015, including the taxable year ending on December 31, 2011, taxpayers may apply either (i) Treas. Reg. § 1.41-4(c)(6) as contained in 26 CFR part 1 (revised as of April 1, 2003) and IRB 2001-5 (*see* www.irs.gov/pub/irs-irbs/irb01-05.pdf), or (ii) all of Treas. Reg. § 1.41-4(c)(6) as contained in IRB 2002-4. The 2016 Regulation permits the taxpayer to select which version of Treas. Reg. § 1.41-4 will apply; however, the taxpayer must apply such version of the regulation in its entirety.

The preambles to the Comptroller's Draft Proposed Rules state that, "[a]lthough the federal regulations allow taxpayers to choose whether they follow this prior IRS guidance, the options are not included in the term 'Internal Revenue Code' because Treasury Regulation § 1.41-4(e) does not require taxpayers to follow either of those options." In other words, the Draft Proposed Rules read the statute's use of the word "applicable" to encompass only mandatory (i.e., "required") treasury regulation provisions, but not permissive provisions. We respectfully suggest that such a narrow interpretation appears inconsistent with the plain language of Texas Tax Code §§ 151.3182(a)(2) and 171.651(1). We further respectfully note that one consequence of the Comptroller's interpretation in the Draft Proposed Rules is that some taxpayers could be prohibited from including in their calculation of the Texas R&D Credit or the Texas R&D Exemption any costs related to the development of internal use software, even when such taxpayers would be permitted to include such costs in their IRC § 41 credit calculation for federal tax purposes. This could result in taxpayers not receiving a Texas R&D Credit or Texas R&D Exemption for any costs associated with the development of internal use software.

Texas Tax Code §§ 151.3182(a)(2) and 171.651(1) define "Internal Revenue Code" to include all regulations "applicable" to the federal tax year ending December 31, 2011. The 2016 Regulation is, by its terms, clearly "applicable" to the federal tax year ending December 31, 2011, and with respect to internal use software, permits taxpayers to elect one of two options for such federal tax year ending December 31, 2011. We respectfully suggest that the Comptroller's interpretation that a treasury regulation must *mandate* its application to the federal tax year ending December 31, 2011, in order to apply for Texas franchise tax and sales tax purposes, effectively limits the ability to make a choice that is afforded to taxpayers under the relevant treasury regulations. In fact, because the Internal Revenue Service permits taxpayers to choose either of the versions of the relevant treasury regulations, neither version is mandatory, and we respectfully note that the Comptroller's interpretation therefore could result in application of neither version of the treasury regulation for Texas franchise tax and sales tax purposes.

We respectfully propose that the better reading of the term "applicable," as used in Texas Tax Code §§ 151.3182(a)(2) and 171.651(1), is that it refers to a regulation that may legally be applied to the federal tax year ending December 31, 2011. This would allow taxpayers to exercise their options as provided in the treasury regulations, including as set forth in the 2016 Regulation, and would keep Texas law aligned with federal law, which is consistent with the intent of the Texas Legislature. Further, this would preserve the federal election that allows taxpayers to determine whether to include costs associated with the development of internal use software in their calculations of qualified research expenses.

B. The Definition of Internal Use "Software" Should Be Updated to Reflect Current Economic Realities

As currently drafted, subsection (d)(5)(A) of the Draft Proposed Rules defines the term "internal use software" as "computer software developed by, or for the benefit of, the taxable entity primarily for internal use by the taxable entity." Further, the Draft Proposed Rules exclude from the definition of "internal use software" software that "is developed to be commercially sold, leased, licensed, or otherwise marketed for separately stated consideration to unrelated third parties. . . ." *Id.* The "separately stated consideration" requirement was first put forward by the IRS and Treasury in a notice of proposed rulemaking (REG-112991-01), reflecting their review of TD 8930 (the "2001 Proposed Rule"). *See* Federal Register (66 FR 66362). The 2001 Proposed Rule concluded that unless computer software is developed to be commercially sold, leased, licensed, or otherwise marketed for separately stated consideration to unrelated third parties, computer software is presumed to be developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use.

The 2001 Proposed Rule does not take into account certain economic arrangements that have developed since its promulgation. For example, this "separately stated consideration" requirement does not exempt (i) free software, (ii) software that earns money through the use of advertisements, (iii) software that is initially free, but has unlockable premium features, (iv) pay-what-you-want software, or (v) software that relies on the sale of collected data for revenue, etc.

To address the ambiguities presented by the examples described above, Treasury and the IRS have reformed the exclusion from internal use software to exempt "software commercially sold, leased, licensed, or otherwise marketed to third parties, and software that is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system." TD 9786. This reformed exclusion is incorporated into current Treas. Reg. § 1.41-4(c)(6)(iv), which applies to federal taxable years beginning on or after October 4, 2016. As a result, there is no longer a separately stated consideration requirement.

Because the reformed exclusion from internal use software does not apply to federal tax year ended December 31, 2011, it is not included under Texas Tax Code §§ 151.3182(a)(2) and 171.651(1). We respectfully note that, as a result, Texas franchise tax and sales tax law suffer from the same ambiguities that Treasury and the IRS addressed with respect to federal taxable years beginning on or after October 4, 2016. Therefore, we respectfully suggest that the Comptroller consider addressing such ambiguities by adopting the same revisions to the exclusion from internal use software adopted by Treasury and the IRS.

III. REQUEST FOR ROUNDTABLE DISCUSSION

Before publishing any version of the Draft Proposed Rules in the Texas Register, we respectfully request that the Comptroller convene a roundtable discussion of interested taxpayers and practitioners to address issues relating to the Draft Proposed Rules. We would welcome the opportunity to participate in such a meeting.

IV. CONCLUSION

We greatly appreciate the opportunity to work with the Comptroller on these significant tax issues and hope these Comments provide relevant analysis for your review. Thank you for your consideration.