KM KREIG MITCHELL LLC
Attorneys at Law

April 26, 2021

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

Re: Comments to Proposed Changes to 34 TAC §§ 3.599 and 3.340 for the Texas Research Tax Credit

Dear Ms. Bostick,

I am writing on behalf of Kreig Mitchell LLC, a Texas law firm, to provide comments on the new rules set out in the Proposed Rules for 34 TAC §§ 3.599 and 3.340 for the Texas research tax credit (the "Proposed Rules"). The Proposed Rules were published in the Texas Register on April 16, 2021. 46 Tex. Reg 2555 and 46 Tex. Reg. 2565.

The Proposed Rules include new rules for what counts as a "business component" that are inconsistent with existing law and include language that is internally inconsistent. The new rules raise more questions than they provide answers. Moreover, the new rules will hurt our economy in Texas, result in the loss of jobs in Texas, and drastically limit the availability of the research tax credit for a large group of taxpayers with no stated policy objective for doing so.

The Proposed Rules should be changed to confirm that service providers and those that produce technical designs by meeting the Four-Part Test and limitation rules in our existing laws do qualify for the research tax credit in Texas. This is needed to keep these highly sought-after jobs in Texas and make Texas more competitive in attracting these jobs to our state.

About the Business Component

The Federal and state research tax credits incorporate the concept of a "business component." The business component is unique to the research tax credit. It is a method for grouping research activities so that the Four-Part Test and detailed exclusion rules can be applied to the activities. The Four-Part Test and detailed exclusion rules define what activities are qualified for the credit. The "business component" is similar to job costing or project accounting whereby costs are associated with projects to evaluate the costs for each job.

The business component is "any product, process, computer software, technique, formula, or invention." If the Four-Part Tests are not met for the broadest business component, then one is to "shrink-back" to the most significant subset of elements of the product, process, computer software, technique, formula, or invention until the Four-Part Test is met.

These rules can be found in the Federal and Texas research tax credit statutes and regulations. The Proposed Rules do not make significant changes to these rules.

The New Business Component Rules in the Proposed Rules

The Proposed Rules depart from Federal and Texas statutes by adding two entirely new rules for the business component:

> (i) If a taxpayer provides a service to a customer, the service provided to that customer is not a business component because a service is not a product, process, computer software, technique, formula, or invention. However, a product, process, computer software, technique, formula, or invention used by a taxpayer to provide services to its customers may be a business component.
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> (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.

The new rule in subparagraph (i) eliminates the research tax credit for those who perform services. The new rule in subparagraph (ii) eliminates the credit for those who do research to design products that others construct or manufacture. This is a significant change that goes well beyond the current Texas statute.

A Service Provided to a Customer Can be a Business Component

The Proposed Rules provide a new rule saying that a "service provided to ... [a] customer is not a business component because a service is not a product, process, computer software, technique, formula, or invention." This new rule is in error. A service provided to a customer can be a business component.

Research is a service. The Four-Part Test (and limitations set out in the rules) goes into great detail to define what activities are qualified. These activities are performed by employees and contractors.

A taxpayer who is hired to perform research for another party may be hired to perform a service. If the service is to result in an identifiable product or other deliverable or the delivery of a result to a customer, the taxpayer has sold a product. The product is the thing or the result that is delivered.

This is consistent with the definition of the term "product." The Merriam-Webster Dictionary includes the following definition of the term product -"something (such as a service) that is marketed or sold as a commodity." Some of the synonyms for this term include a "thing," "work," and "yield."

As applied to an engineering firm that is hired to perform a service by coming up with the design for an innovative structure, the design of the structure is the engineering firm's product. This is true even if the engineering firm sells the design to a third-party and the third party constructs or manufactures the structure.

The Proposed Rules use this very example:

> 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.

What this example is missing is that the research tax credit rules are applied from the vantage point of the taxpayer who is taking the credit. In the example, if it is the engineering firm that is taking credit, one has to consider what product the engineering firm is selling. One does not look at the product that a third party who uses the designs purchased from the engineer is selling if they are not the ones taking the research tax credit. The new rule and example in the Proposed Rules err by viewing the research tax credit from the vantage point of the wrong taxpayer.

Importantly, it should also be noted that research activities to design a structure will not qualify for the credit if the business component is the structure as stated in the example. The structure would either be inventory or depreciable property for the taxpayer if the taxpayer retains the business component or the activities would be manufacturing activities if the taxpayer produced and then sold the business component. The existing rules make it clear that inventory and depreciable property and manufacturing activities are not qualified for the research tax credit. *TG Missouri Corp. v. Comm'r*, 133 T.C. No. 13 (2009) (concluding that molds designed and retained by the taxpayer did not qualify for the credit); Treas. Reg. § 1.174-2(b); *Kollsman Inst. Corp. v. Comm'r*, 51 T.C.M. (CCH) 463 (1986), aff'd, 870 F.2d 89 (2d Cir. 1989) (concluding that the delivery of a tangible product rather than a service does not qualify as research). Thus, the new rule creates a "heads you lose, tails I win" scenario. The taxpayer either provides a service and does not qualify under the new rule or they are creating depreciable property or inventory or engaged in manufacturing activities and do not qualify under the existing rules.

The only solution that makes the example work is if, contrary to the new rule in the Proposed Rules, services that lead to a product or result qualify for the credit. The reason why this solution works is that research is by definition, and by operation of the existing tax credit rules, a service. This is how the rules have worked and been applied since the tax credit was first enacted into law.

A "Design" Can be a Business Component

The Proposed Rules provide a new rule saying that a "design is not a product, process, computer software, technique, formula, or invention." This new rule is also incorrect. A "design" can be a business component.

The term "design" that is found in the Proposed Rules is not defined in the Proposed Rules. The terms "product," "technique," "formula," and "invention" that are found in the statute and the regulations are also not defined. Our laws generally apply the common meaning of undefined terms. The common meaning of these terms shows that a "design" can be a "technique"or a "product."

The Merriam-Webster Dictionary includes the following definitions:

> Design - "a plan or protocol for carrying out or accomplishing something (such as a scientific experiment)." Some of the synonyms for this term include a "blueprint," "master plan," and "plan."
>
> Product -"something (such as a service) that is marketed or sold as a commodity." Some of the synonyms for this term include a "thing," "work," and "yield."
>
> Formula - "a general fact, rule, or principle expressed in mathematical symbols." Some of the synonyms for this term are "design" and "blueprint."
>
> Technique - "a method of accomplishing a desired aim." A synonym for this term includes "technique."

Applying these definitions, for the research tax credit, a "design" is a plan for how to make or construct something. A "design" is a "thing," which is the common meaning of what a "product" is. This is a "product" given the common definition of the term if the taxpayer is in the business of doing research to produce designs that it sells to others.

A "design" is also a "technique" or "formula" under the common definitions of these terms. A "technique" or "formula" is a plan for how to make or

construct something. This is the same as a "blueprint," which is the common meaning for a "design."

The plain meaning of these terms leads to only one conclusion. If the taxpayer does research to produce designs that it sells to others, the business component for the taxpayer is the design and the design is a product, formula, or technique. The "design" satisfies the definition of what counts as a business component in the Texas statute.

The new rule in the Proposed Rules expressly contradicts these common meanings. It does so and does not offer any explanation or justification for doing so.

The New Business Component Rules are Not Needed

The new rules in the Proposed Rules redefine what counts as a business component are not needed. The existing rules define what counts as a business component and provide an overriding shrinking-back rule that already alleviates questions about what counts as a business component.

The current rules provide a very broad definition of what counts as a business component, i.e., "any product, process, computer software, technique, formula, or invention." The existing rules say that the research merely has to be "useful" in the development of a business component. A business component doesn't even have to be developed. The research, which is a service, could fail and no business component may be developed. This failure is not a bar to taking the research tax credit.

Then the rules include a shrinking-back rule that is applied liberally. The Federal regulations say that "[t]he shrinking-back rule is not itself applied as a reason to exclude research activities from credit eligibility." The courts have said that the failure to identify the precise business component by applying the shrinking-back rule "is not itself a reason to exclude activities from credit eligibility." *Suder v. Comm'r*, T.C. Memo. 2014-201; *Siemer Milling Co. v. Comm'r*, T.C. Memo. 2019-37 (noting that the taxpayer has been inconsistent in its description of business components to which each project relates, but concluding that the inconsistency was of no consequence).

The reason for this broad definition and liberal application of the

shrinking-back rule is that the focus is on measuring whether the Four-Part Test and detailed limitations have been met. These detailed tests and rules define whether qualified research activities are performed. These detailed tests and rules already exclude activities that are not qualified. This should be the focus of any inquiry about the research tax credit and whether a taxpayer is entitled to credit.

The new rules in the Proposed Rules are a red herring. They distract from the real issue—namely, whether qualified research activities are performed under the existing detailed qualification rules. By putting up a roadblock for service providers and those who sell designs to others, the Proposed Rules shift the focus to the business component and away from the existing detailed tests and rules.

The fallacy in imposing a roadblock for these taxpayers is apparent when one considers the imprecision in the research tax credit calculation. The research tax credit statute does not provide a calculation that simply takes the research expenses and multiplies the expenses by a percentage to compute the amount of the tax credit. The statute provides a calculation that results in high-level estimation.

The research tax credit is calculated by taking certain qualified expenses associated with business components for the current year, comparing those expenses to similar expenses for a base period (the expenses for both periods are increased from 80 percent to 100 percent by a "substantially all" rule and reduced by 35 percent for contract costs), and reducing the result of the difference between the totals for the two periods by 50 percent. The result of that calculation is then multiplied by 20 percent. If a reduced credit is elected, the result is reduced by another percentage equal to the highest corporate tax rate for the year.[1] Thus, the research tax credit calculation itself is best described as an estimate of an estimate.

There is no need to include new rules to further define business components when all one is doing in performing the calculation for the research tax credit is making a high-level estimate. The new rules do not make the research tax

[1] This is the so-called regular method for computing the credit. If the taxpayer is a start-up company the research tax credit just applies an arbitrary 3 percent fixed base percentage rule to compute the credit (or a six percent amount if the taxpayer is a new taxpayer and elects the alternative simplified credit).

credit anything other than an estimate of an estimate.

The New Business Component Rules are Inconsistent With the Policy for the Texas Research Tax Credit

The Proposed Rules offer no insight as to what policy objective is supported by denying credit to service providers and those who perform research to sell designs to third parties.

The IRS statistics show that service providers account for about 30 percent of all research tax credits taken at the Federal level.[2] The percentage is likely similar for Texas' research tax credit. If the Proposed Rules could potentially eliminate 30 percent of the research tax credits taken by taxpayers in Texas, it should only do so based on a clear and sound policy.

No policy supports denying a research credit to taxpayers who perform research that meets the Four-Part Test and detailed exclusions just because they (1) provide services or (2) produce designs to sell to others.

The Texas research tax credit is intended to reward taxpayers who increase their qualified research spending in Texas. The largest driver of the amount of the research tax credit is wages paid to employees to perform research in Texas. Thus, the Texas research tax credit is a job credit.

These research jobs are extremely important for the Texas economy. These are the jobs that bring prosperity to our local economies. Researchers who perform services and produce designs are often high-paid salaried employees. They work in stable industries that pay wages year after year. This group includes engineers, architects, and other specialized technical consultants.

These high-paid jobs also have spillover effects for our local economies. They bring skilled workers into our local economies who spend their earnings in our local economies, foster innovation in our local economies, result in start-up companies and innovation in our local economies, and provide jobs for graduates from our local colleges and universities. They also bring in funds from outside of the state and make the state less dependent on out-of-state technical expertise.

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[2] https://www.irs.gov/pub/irs-soi/14co01rsrchcr.xlsx.

These research jobs are highly mobile. The workers are not tied to manufacturing plants or locally sourced supply chains. They can easily be moved to other states. Texas is in direct competition with other states for these highly sought-after jobs. For example, a taxpayer in California faces a much higher tax (9% state income tax versus the 3% Texas franchise tax), but California offers a much more generous research tax credit. The California research tax credit can result in the taxpayer paying very little in state income taxes for gross receipts earned by its high-paid employees who work in California. This encourages taxpayers to keep these highly sought-after jobs in California. Several other states also have enacted similarly generous research tax credits. The Texas research tax credit is much smaller in amount. This is already a problem for Texas.

The new rules in the Proposed Rules that expressly deny credit for these jobs in Texas greatly exacerbate this problem for Texas. They provide a strong incentive for taxpayers to keep these high-paid jobs outside of Texas. Keeping these highly sought-after jobs out of Texas is not a sound policy justifying these new rules.

The new rules in the Proposed Rules should be changed to make it clear that these jobs should remain in Texas and that others should relocate these jobs to Texas. It could do this by simply confirming that:

> (i) If a taxpayer provides a service to a customer, the service provided to that customer can be a business component if it is intended to culminate in a product or result that can be identified.
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> (ii) A design is a business component if the taxpayer is in the business of producing and selling designs to third parties. For example, the design of a structure is a business component if the taxpayer is in the business of designing structures. The blueprint or other plan that embodies the design is not the business component, but rather, the component embodied or depicted in the blueprint or other plan is the business component.

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Thank you in advance for considering these comments. I can be reached at (713) 909-4906 should you have any questions about these comments.

Sincerely,

Kreig D. Mitchell