

Research and Development Exemption

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Research and Development Exemption

Depreciable Research and Development Equipment

The legislature enacted a sales tax exemption for depreciable equipment used in research and development defined by reference to the Internal Revenue Code (IRC). The legislative intent was to encourage economic development in Texas related to research and development activities.¹⁴⁹ This exemption has been widely applied by manufacturers. Under the statute, “depreciable tangible personal property” means tangible personal property with a useful life of more than one year, which is subject to depreciation under generally accepted accounting principles (GAAP) or IRC §§ 167 or 168.¹⁵⁰ “Research and development” means all research and development activities, with research being study directed toward knowledge and understanding, and development being the use of knowledge and understanding gained from research.

“Qualified research” is defined by reference to IRC § 41. In particular IRC §§ 41(d) and 174 require that qualified research be technological in nature, develop a new or improved business component, or constitute part of an experimentation process relating to a new or improved function, performance, reliability, or quality. Design changes related to style, taste, cosmetic, or seasonal factors; research conducted after commercial production has begun; research adapting an existing product or process to a specific customers’ need; or duplication of an existing product or process is not qualified research. Qualified research also does not include surveys or studies; research relating to internal-use software; research conducted outside the US and its possessions; research in social sciences, arts or humanities; or research funded by another person or governmental entity.

The sales tax exemption applies to the sale, storage, or use of depreciable tangible personal property directly used in qualified research if the property is sold, leased, or rented to, or stored or used by, a person who:

(1) is engaged in qualified research; and

(2) will not claim a research and development credit under the franchise tax,¹⁵¹ either individually or as a member of a combined group, for the period during which the sale, storage, or use occurs. The exemption expires December 31, 2026.

To qualify the depreciable tangible personal property must have a useful life of more than one year; be subject to depreciation under the federal tax code; be sold, leased, rented to, or stored by a person engaged in qualified research; and be directly used in qualified research. In this case, “direct” means it has an immediate effect on the property or in an activity, without an intervening, ancillary, or prior effect.

¹⁴⁹ HB 800 (2013 legislature) (effective January 1, 2014).

¹⁵⁰ With reference to the effective IRC under the franchise tax.

¹⁵¹ Section 171.0002 Subchapter M, Chapter 171.

The Comptroller's office has prepared forms and instructions for claiming the exemption. The forms and instruction are available on a special web page set up for the exemption: <https://www.comptroller.texas.gov/taxes/qualified-research/>. The rules generally follow the requirements for the federal exemption, which was pending expiration at the time these materials were prepared.

Qualified Enterprise Projects

Effective September 1, 2015, SB 100 removes the cap placed on capital investments for qualified enterprise projects. An enterprise project can qualify for a tax refund based on their capital investment. The bill removes the cap of \$149,999,999 placed on capital investment that results in a refund of \$2,500 per job.¹⁵² Enterprise projects with capital investments of \$150,000,000 or more will receive refunds for new permanent jobs. The refund per job has been changed to capture only new permanent jobs. The bill adds the definition of a half enterprise project and provides that the maximum sales tax refund a half enterprise project may receive is \$125,000.

Legislative and Rule Changes Affecting Manufacturers

Exempt Data Center Qualifying Jobs

Effective June 1, 2017, House Bill 4038 eases the definition of a “qualifying job” for the data center exemption. The 2015 legislature granted a temporary sales tax exemption for property used in data centers. An eligible data center is one that is at least 100,000 square feet in a single building in Texas that is specifically constructed or refurbished for and actually used primarily to house servers and related equipment and support staff for processing, storing and distributing data. The data center must have an uninterruptible power source, generator backup power, a sophisticated fire suppression and prevention system, and enhanced physical security that includes restricted access, video surveillance, and electronic systems. Eligible data centers must provided a minimum of qualifying jobs. There are also specific detailed requirements that apply. It is a very specialized and narrowly-focused exemption designed to benefit a very specialized industry.

The Comptroller revised Rule 3.335 on the temporary exemption for tangible personal property used in a qualifying data center or qualifying large data center projects to reflect prior legislation. Exemptions are available for projects that meet certain capital investment and job creation requirements. The exemption for a qualifying data center applies only to state sales tax while the exemption for a qualifying large data center applies to both state and local sales taxes. The amendments add definitions of key terms and identify which provisions apply to both types of projects. Provisions are reorganized and renumbered for clarity and readability.¹⁵³

¹⁵² The bill amends Tax Code Section 151.429.

¹⁵³ *Texas Register* (March 10, 2017; 42 TexReg 1129). 34 TAC §3.335.

Master Recordings and Broadcasts

The Comptroller promulgated new rule 3.350 (Master Recordings and Broadcasts), which defines key terms, identifies exempt items and qualified persons and locations, provides examples of nonexempt items and services, and discusses reports, exemption certificates, and divergent use.¹⁵⁴ Rule 3.350 (1)(1) imposes sales and use tax on divergent use based on the fair market rental value of the tangible personal property for the period of time used in the taxable manner. A divergent use occurs when a taxable item purchased tax-free under a properly completed exemption certificate is used in a taxable manner. Taxpayers claiming the exemption must maintain records to document any taxable use of an item purchased tax-free, and the payment of sales and use tax due on such use.

Rule 3.350 (d)(2) provides the following examples of nonexempt items used in production, which include, but are not limited to: tents for catering or staging areas; office furniture; crew jackets; flowers for dressing rooms; catering or other food ready for immediate consumption; bodyguard services; script typing; landscape maintenance; director's chairs; gas cans; ladders; shipping cases; battery chargers; mobile offices; pagers, cellular phones, and other communication equipment (except those used exclusively on the set); telecommunications services such as mobile phone service; waste removal (including waste that will be recycled); wardrobe racks; and alcoholic and non-alcoholic beverages.

Rule 3.350 (e) clarifies how transportation equipment is taxed. Specifically, motor vehicles, including trailers and semitrailers, are subject to motor vehicle sales tax and are exempt from sales and use tax, regardless of whether they are used in production. Other types of machinery, equipment, or supplies used in transportation activities, such as helicopters, do not qualify for exemption from sales and use tax under this section.

Rule 3.350 also clarifies what natural gas and electricity usage may qualify for exemption and what equipment repairs may be exempt.

¹⁵⁴ *Texas Register* (November 25, 2016; 41 TexReg 9228). 34 TAC §3.350 (Master Recordings and Broadcasts), effective February 1, 2017.

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