Texas Comptroller of Public Accounts STAR System

202102006H

SOAH DOCKET NO. 304-19-4387.13
CPA HEARING NO. 115,317
RE: **************
TAXPAYER NO: **************
AUDIT OFFICE: **************
AUDIT PERIOD: January 1, 2013 THROUGH December 31, 2013

SOAH DOCKET NO. 304-19-4389.13
CPA HEARING NO. 115,318
RE: **************
TAXPAYER NO: **************
AUDIT OFFICE: **************
AUDIT PERIOD: January 1, 2012 THROUGH December 31, 2012

SOAH DOCKET NO. 304-19-4388.13
CPA HEARING NO. 115,319
RE: **************
TAXPAYER NO: **************
AUDIT OFFICE: **************
AUDIT PERIOD: January 1, 2014 THROUGH December 31, 2014

SOAH DOCKET NO. 304-19-4390.13
CPA HEARING NO. 115,320
RE: **************
TAXPAYER NO: **************
AUDIT OFFICE: **************
AUDIT PERIOD: January 1, 2016 THROUGH December 31, 2016

SOAH DOCKET NO. 304-19-4391.13
CPA HEARING NO. 115,321
RE: **************
TAXPAYER NO: **************
AUDIT OFFICE: **************
AUDIT PERIOD: January 1, 2015 THROUGH December 31, 2015

Franchise Tax/RFD

BEFORE THE COMPTROLLER
OF PUBLIC ACCOUNTS
OF THE STATE OF TEXAS

GLENN HEGAR
Texas Comptroller of Public Accounts

JON MARK ROSS
Representing Respondent

****
Representing Claimant

COMPTROLLER'S DECISION

This decision is considered final on March 1, 2021, unless a motion for rehearing is timely filed; this date of finality is calculated based on the Administrative Procedure Act (APA). [1] **The failure to timely file a motion for rehearing may result in adverse legal consequences.**

Administrative Law Judge (ALJ) Trevor Moore of the State Office of Administrative Hearings (SOAH) issued a Proposal for Decision (PFD) that includes Findings of Fact and Conclusions of Law. SOAH served the PFD on each party and each party was given an opportunity to file exceptions and replies with SOAH in accordance with SOAH's rules of procedure. The ALJ amended the PFD. The ALJ recommended that the Comptroller adopt the Amended PFD as written.

After review and consideration, IT IS ORDERED that the Amended PFD is adopted as written.

The results from this Decision are Attachments A. The ALJ's letter to the Comptroller is Attachment B. The Amended PFD as written is Attachment C. Attachments A, B, and C are incorporated by reference.

Attachments A reflect zero amounts due.

SIGNED on this 3rd day of February 2021.

GLENN HEGAR
Comptroller of Public Accounts

By: Lisa Craven
Deputy Comptroller

Attachments A, Texas Notifications of Hearing Results
Attachment B, ALJ's letter to the Comptroller
Attachment C, Amended Proposal for Decision as written

ATTACHMENT B

State Office of Administrative Hearings
Kristofer Monson
Chief Administrative Law Judge

January 21, 2020

The Honorable Glenn Hegar
Comptroller of Public Accounts
LBJ Building
111 E. 17th Street, 1st Floor
Austin, TX 78701

RE: SOAH Docket: 304-19-4387.13
TCPA Hearing No.: 115,317 et. seq.
Taxpayer No.: **************
************** v. Texas Comptroller of Public Accounts

Dear Comptroller Hegar:

Please be advised that Staff filed exceptions to the Proposal for Decision (PFD) in this matter on December 18, 2020. Petitioner filed exceptions on January 11, 2021, and Staff filed a response on January 15, 2021.

In its exceptions, Staff argues Claimant's burden of proof is a preponderance of the evidence, not clear and convincing evidence. Petitioner did not respond to Staff's exceptions. The ALJ agrees with Staff's exceptions and has amended the PFD with regard to the statement of the burden of proof. This change does not constitute a substantive amendment that would afford the parties an opportunity to file exceptions.

Petitioner's exceptions emphasize the arguments presented in the hearing. That is, Petitioner maintains all research costs presented by the Claimant are captured in research cost centers, are costs that are "incident" to the research process and deductible under IRC Section 174, and should be considered to qualify as COGS under Texas Tax Code § 171.1012(c)(9). Claimant maintains the COGS deductions under Section 171.1012 should be interpreted broadly, and any other interpretation would "contravene the plain language and grammatical structure" of (c)(9). As stated in the PFD, the language of the statute and Comptroller's policy support a conclusion that, based on the language of IRC Section 174 and the COGS deduction in Texas Tax Code § 171.1012(c)(9), a "taxable entity may include in its COGS deduction research, experimental, engineering, and design activity costs, including all research or experimental expenditures described by Section 174 of the IRC, relating to goods it sells." *See* STAR Accession No. 201504069L. Petitioner's evidence reflects the amount of research and development expenditures Claimant recorded in its federal income tax returns for each of the report years at issue. However, Petitioner's evidence did not provide support for a conclusion that the costs included in those returns were attributable to research, experimental, engineering, and design activity costs, including all research or experimental expenditures described by IRC Section 174, relating to goods Claimant sells.

A copy of the Amended PFD is attached. The ALJ recommends that the Amended PFD be adopted as written.

Sincerely,

Trevor Moore
Administrative Law Judge

ATTACHMENT C

SOAH DOCKET NO. 304-19-4387.13
TCPA DOCKET NO. 115,317
****
Taxpayer No. **************

SOAH DOCKET NO. 304-19-4388.13
TCPA DOCKET NO. 115,318
****
Taxpayer No. **************

SOAH DOCKET NO. 304-19-4389.13
TCPA DOCKET NO. 115,319
****
Taxpayer No. **************

SOAH DOCKET NO. 304-19-4390.13
TCPA DOCKET NO. 115,320
****
Taxpayer No. **************

SOAH DOCKET NO. 304-19-4391.13
TCPA DOCKET NO. 115,321
****
Taxpayer No. **************

v.

TEXAS COMPTROLLER OF PUBLIC ACCOUNTS

BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS

AMENDED PROPOSAL FOR DECISION

************** (Claimant) filed amended franchise tax returns for report years 2012 through 2016, claiming refunds due to business loss carryforward credits and costs of goods sold (COGS) deductions. The Tax Division (Staff) of the Texas Comptroller of Public Accounts (Comptroller) granted the claims in part. The denied COGS deductions remain in contention. In this Amended Proposal for Decision, the Administrative Law Judge (ALJ) finds Claimant's evidence is insufficient to support the claimed deductions in each report year and, therefore, the partial refund denials should be upheld.

I. PROCEDURAL HISTORY, NOTICE, AND JURISDICTION

Staff referred the above-referenced cases to the State Office of Administrative Hearings (SOAH) and, on May 8, 2019, issued Notices of Hearing. On May 9, 2019, ALJ Trevor Moore issued Order No. 1, which combined the cases and set out the pre-hearing requirements. ************** of COMPANY represented Claimant, and Jon Ross represented Staff. The telephonic hearing convened on December 1, 2020. The record closed at the conclusion of the hearing.

There are no issues of notice or jurisdiction; therefore, those matters are set out in the Findings of Fact and Conclusions of Law without further discussion.

II. REASONS FOR DECISION

A. Evidence Presented

Staff presented the testimony of auditor David Tu and offered the following exhibits for each hearing:

1. 60-Day Letter;
2. Refund Audit Report;
3. Refund Audit Plan;
4. Refund Claim;
5. Certified Audit Schedules;
6. Certified Amended Audit Schedules;
7. Auditor's Summary Statement;
8. Texas Tax Code § 171.1012;
9. Texas Administrative Code § 3.588;
10. 26 C.F.R. § 1.174-2; and
11. Audit Techniques Guide: Credit for Increasing Research Activities.

Claimant did not present testimony, but offered the following exhibits:

1. Email from J. Mark Ross;
2. Description of Business (Fiscal Year 2015 10-K);
3. Excerpt from Fiscal Year 2015 Federal R&D Study;
4. Internal Revenue Code (IRC) Section 41;
5. 26 C.F.R. § 1.174-2;
6. Fiscal Year 2013 10-K Excerpt (Products Research and Development);
7. Fiscal Year 2014 10-K Excerpt (Products Research and Development); and
8. Fiscal Year 2015 10-K Excerpt (Products Research and Development).

The parties' exhibits were admitted without objection.

B. Agreed Adjustments

Staff did not agree to any additional refunds.

C. Material Facts

Claimant is a California company engaged in the design, manufacture, marketing, sales, and servicing of semiconductor equipment used in the fabrication of integrated circuits. Claimant filed amended franchise tax returns for report years 2012, 2013, 2014, 2015, and 2016, reflecting adjustments to its COGS deductions. Claimant also requested adjustments for business loss carryforward amounts in multiple periods. Staff audited the claims, and refunds were granted for both COGS and business loss carryforward amounts.

Regarding the COGS deductions that remain at issue, the refund claims consisted of the amended returns incorporating COGS deductions for research and development activities that included of the amounts Claimant claimed as a credit for expenses for qualified research under 26 U.S. Code § 41 (IRC Section 41) on its federal income tax returns (FITRs), Form 6765. The auditor, David Tu, initially agreed to allow the COGS deductions up to the amount reported on Form 6765, but denied the excess amount and requested additional documentation to support the denied portions of the claims.

In response to Mr. Tu's request for documentation regarding the nature of the expenses identified by Claimant as research and development expenses in its FITRs and included in its amended franchise tax returns, Claimant identified numerous expense accounts. Considering the account descriptions, Mr. Tu determined those which he believed qualified as expenses for research and development activities related to goods sold by Claimant. However, he denied the expenses included in several accounts due to the uncertainty regarding how the expenses, as described, qualified for the deduction. For example, expenses for several accounts with the largest dollar amounts were denied, including accounts such as "salary and wages," "bonus," "depreciation expense," "restricted stock plan," "expatriot [*sic*] tax," "rent building/office," "maintenance/contract agreements," "airline tickets," "cellular phones," "cost center to cost center allocation," "IO settlement postings to F1," and "NA benefits allocation." Claimant requested a refund hearing for the denied amounts, contending all of the expenses associated with the denied accounts represent qualifying COGS deductions.

Claimant contends the denied accounts all represent expenses for qualifying research or experimental expenditures under IRC Section 41 and 26 U.S. Code § 174 (IRC Section 174) that were properly claimed on Form 6765. Therefore, Claimant maintains, the costs are qualifying COGS. Claimant's representative noted the accounts in dispute were "book" accounts that accumulated qualifying IRC Section 174 expenses for purposes of Claimant's 10-K, and not "tax" accounts that may provide a more accurate reflection of COGS-qualifying expenses. Therefore, Claimant's representative conceded, there were some expenses in the denied accounts that probably did not qualify as research and development expenses for purposes of the COGS deduction. However, he argued, everything that qualifies for the federal research credit under IRC Section 41 and reported on form 6765 has to be an IRC Section 174 research expense and, therefore, the majority of the expenses in the denied accounts are qualifying COGS deductions.

There is no dispute that, during the periods at issue, Claimant produced and sold semiconductor equipment and provided related services. The evidence in the record demonstrates Claimant's products are used primarily in front-end wafer processing, which involves the steps that create the active components of semiconductor devices and their wiring. In addition, Claimant also builds equipment for back-end wafer-level packaging and for related manufacturing markets such as microelectromechanical systems. In its annual 10-K filings during the report years at issue, Claimant discussed its research and development expenses. For example, in its Fiscal Year 2014 10-K, under the heading Research and Development, Claimant stated, "we devote a significant portion of our personnel and financial resources to research and development ('R&D') programs and seek to maintain close and responsive relationships with our customers and suppliers" and "[T]he majority of R&D spending over the past three years has been targeted at deposition, etch, single wafer clean, and other semiconductor manufacturing products."

Claimant maintains the research and development expenses that remain at issue qualify as such per the IRC 174 and, therefore, should be considered to qualify as COGS deductions under Texas Tax Code § 171.1012(c)(9). Staff disagrees, arguing that not all expenses that qualify for the federal research and development credits and deductions under IRC 174 necessarily relate to products that Claimant sold, a requirement for COGS.

D. Analysis and Recommendation

If the Comptroller finds that an amount of tax, penalty, or interest has been unlawfully or erroneously collected, the Comptroller shall credit or refund the amount. Tex. Tax Code § 111.104(a). When a taxpayer requests a refund, it must establish by a preponderance of evidence that taxes were erroneously collected or paid. *See, e.g.,* Comptroller's Decision No. 109,787 (2015); 34 Tex. Admin. Code § 1.26(e). However, in a contested case hearing, the taxpayer has the burden to prove by clear and convincing evidence that the taxpayer or a transaction qualifies for an exemption or a deduction tantamount to an exemption. 34 Tex. Admin. Code § 1.26(c). The Texas Supreme Court recently concluded the COGS deduction is not an exemption or tantamount to an exemption. [2] Therefore, Petitioner's burden of proof in the case at bar is a preponderance of the evidence.

Pursuant to Texas Tax Code § 111.0041, a taxpayer must produce contemporaneous records and supporting documentation for the transactions in question to substantiate and enable verification of the taxpayer's claim related to the amount of tax, penalty, or interest to be assessed, collected, or refunded. *See* 34 Tex. Admin. Code § 1.26(a). In a suit for a refund, the taxpayer must show not only that it overpaid taxes, but also, the exact amount of the overpayment. *Nabors Drilling Techs. USA, Inc. v. Hegar* , 03-17-00284—CV, 2018 WL 2709201, at *5 (Tex. App–Austin June 6, 2018, pet. filed) (citing *Baker v. Bullock* , 529 S.W.2d 279 (Tex. Civ. App.—Austin 1975, writ ref'd n.r.e.)); *see also, e.g.* , Comptroller's Decision No. 114,611 (2019). Summary schedules and assertions in pleadings are insufficient to meet the burden of proof. *See, e.g.,* Comptroller's Decision Nos. 115,376 (2020).

Franchise tax is imposed on each taxable entity that does business in this state or that is chartered or organized in this state. Tex. Tax Code § 171.001. The taxable margin of a taxable entity is determined by calculating 70% of total revenue from the entity's total business, or by subtracting, at the election of the taxpayer, either COGS or compensation. *Id.* §§ 171.101(a)(1), .1011-.1013. COGS includes all direct costs of acquiring or producing the taxpayer's goods, where "goods" are tangible personal property sold in the ordinary course of business of a taxable entity. *See id* . § 171.1012(a)(1). For example, all direct costs of acquiring or producing goods may be included in a taxpayer's COGS deduction, including costs attributable to research, experimental, engineering, and design activities directly related to the production of the goods, including all research or experimental expenditures described by IRC Section 174. *See id* . § 171.1012(c)(9).

As established, the expenses at issue were included in Claimant's FITR form 6765 for each year at issue, claiming credit for qualified research activities as authorized under 26 U.S. Code § 41 (IRC Section 41). For purposes of the IRC Section 41 credit, the term "qualified research" means research for which expenses may be treated as IRC Section 174 expenses. *See* 26 U.S. Code § 41(d). At the hearing Claimant argued that, because the costs reported in its Form 6765 were research or experimental expenditures described by IRC Section174, they must be considered to qualify as COGS under Texas Tax Code § 171.1012(c)(9). The ALJ disagrees.

The Comptroller's stated policy, and more recent amendment to 34 Texas Administrative Code § 3.588, supports a conclusion that all research or experimental expenditures described by IRC Section174 qualify for the COGS deduction if the expenses relate to goods the taxable entity sells, regardless of whether the entity produces the product. As discussed below, the requirement that costs must relate to a product an entity sells emphasizes the distinction between the COGS deduction and the qualifications for costs under IRC Section174, which applies to expenditures related to products that are sold as well as those that are not sold.

Though Texas Tax Code § 171.1012(c)(9) only includes a reference to the "production" of goods, in March of 2018 the Comptroller's Rule was amended to clarify that a taxable entity "may include in its costs of goods sold calculation the costs attributable to research, experimental, engineering, and design activities directly related to the production of the goods, including all research or experimental expenditures described by IRC § 174 *, regardless of whether the taxable entity is the producer of the goods it sells* " (emphasis added). *See* 34 Tex. Admin. Code § 3.588(d)(9). That amendment brought the Rule in line with the Comptroller's stated change in policy, effective in April 2015. *See* State Tax Automated Research (STAR) Accession No. 201504069L (April 24, 2015). Relevant to the case at bar is the Comptroller's analysis of Section 171.1012(c)(9) and IRC Section 174 as set out in the policy document.

In support of the policy regarding allowable COGS related to research and development costs, the Comptroller first noted that, though IRC Section 174 does not define research and experimental costs, related IRC Section 1.174-2(a)(1) does provide a definition of research and experimental expenditures: "The term research or experimental expenditures, as used in Section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense." *See* IRC Section 1.174-2(a)(1); STAR Accession No. 201504069L. The Comptroller then went on to note that Section 1.174-2(a)(1)-(2) describes what costs are generally included in the term “research and experimental expenditures” as “all such costs incident to the development or improvement of a product.” *See id* . However, unlike the requirements for the COGS deduction, the sale or use of the product is not relevant to a determination of eligibility under Section 174. *See* IRC Section 1.174-2(a)(1). Therefore, expenditures for the research and development of a product that is for internal use or is otherwise incorporated into a taxable entity’s business, and not sold, may qualify as research and experimental expenditures under IRC Section 174. The Comptroller concluded that, based on the language of IRC Section 174 and the COGS deduction in Texas Tax Code § 171.1012(c)(9), a “taxable entity may include in its COGS deduction research, experimental, engineering, and design activity costs, including all research or experimental expenditures described by Section 174 of the IRC, *relating to goods it sells* (emphasis added).” *See* STAR Accession No. 201504069L.

The evidence reflects the amount of research and development expenditures Claimant recorded in its FITRs for each of the report years at issue. However, not all of those costs qualify for the COGS deduction unless they relate to products Claimant sold. The question presented in this case is whether the costs that remain at issue qualify as costs as described in Section 171.1012(c)(9) (which includes all research or experimental expenditures described by Section 174) and, if so, do those costs relate to goods Claimant sells, regardless of whether it is the producer of the goods.

There is no dispute regarding the fact that Claimant sold goods and services during the report years at issue and, as evidenced by Staff’s approval of a portion of the COGS deductions claimed, some of the expenses related to the products that it sold. In determining if the costs that remain denied qualify as COGS, the most detailed evidence consists of the listing of the denied accounts. As described above, those accounts, on their face, provide no support for a conclusion that the costs included therein were attributable to research, experimental, engineering, and design activity costs, including all research or experimental expenditures described by IRC Section 174, relating to goods Claimant sells. Claimant did not submit any additional evidence regarding the denied costs, and conceded the accounts that were denied likely included some costs that did not qualify for the COGS deduction. The ALJ concludes Claimant failed to demonstrate the costs that remain at issue qualify as COGS under Section 171.1012(c)(9). The denials of the refund claims should be affirmed.

III. FINDINGS OF FACT

1. ************** (Claimant) is a California company engaged in the design, manufacture, marketing, sales, and servicing of semiconductor equipment used in the fabrication of integrated circuits.

2. Claimant filed amended franchise tax returns for Texas franchise tax report years 2012, 2013, 2014, 2015, and 2016, reflecting adjustments to its cost of goods sold (COGS) deductions and adjustments for business loss carryforward amounts.

3. The Tax Division (Staff) of the Texas Comptroller of Public Accounts (Comptroller) audited the refund claims and refunds were granted for both COGS and business loss carryforward amounts. A portion of the claimed COGS deductions were denied.

4. The refund claims consisted of the amended returns incorporating COGS deductions for research and development activities that included the amounts Claimant claimed as a credit for expenses for qualified research under 26 U.S. Code § 41 on its federal income tax returns form 6765.

5. In response to the auditor’s request for documentation regarding the expenses identified by Claimant as research and development expenses that qualified as COGS, Claimant identified numerous expense accounts.

6. Considering the account descriptions, the auditor identified those which he believed qualified as expenses for research and development activities related to goods sold by Claimant and allowed the COGS deduction.

7. The auditor denied the expenses included in several accounts due to the uncertainty regarding how the expenses, as described, qualified for the COGS deduction.

8. Claimant timely requested refund hearings to contest the denials.

9. Staff referred the contested cases to the State Office of Administrative Hearings (SOAH), and, on May 8, 2019, issued Notices of Hearings to Claimant.

10. Each notice contained a statement of the nature of the hearing; the date, time and location of the hearing, a statement of the legal authority and jurisdiction under which the hearing was to be held; a reference to the particular sections of the statutes and rules involved; and a short, plain statement of the factual matters asserted, or an attachment that incorporated by reference the factual matters asserted in the complaint or petition filed with the state agency.

11. On May 9, 2019, after concluding the cases shared common issues of fact and law, the Administrative Law Judge issued Order No. 1, which joined the cases and set out the pre-hearing requirements.

12. The telephonic hearing convened on December 1, 2020.

13. The record closed at the conclusion of the hearing.

IV. CONCLUSIONS OF LAW

1. The Comptroller has jurisdiction over this hearing. *See* Tex. Tax Code ch. 111.

2. SOAH has jurisdiction over this hearing, including the authority to issue a proposal for decision with findings of fact and conclusions of law. *See* Tex. Gov't Code ch. 2003.

3. The Comptroller provided proper and timely notice of the hearing. *See* Tex. Gov't Code ch. 2001; Tex. Tax Code § 111.105.

4. If the Comptroller finds that an amount of tax, penalty, or interest has been unlawfully or erroneously collected, the Comptroller shall credit or refund the amount. Tex. Tax Code § 111.104.

5. When a taxpayer requests a refund, it must establish by a preponderance of evidence that taxes were erroneously collected or paid. 34 Tex. Admin. Code § 1.26(e).

6. In a contested case hearing, the taxpayer has the burden to prove by clear and convincing evidence that the taxpayer or a transaction qualifies for an exemption or a deduction tantamount to an exemption. 34 Tex. Admin. Code § 1.26(c).

7. The Texas Supreme Court recently concluded the deduction was not an exemption or tantamount to an exemption. *See Sunstate Equipment Company., LLC v. Hegar* , 601 S.W.3d 685 (Tex. 2020), stating that "Chapter 171 makes clear that the COGS subtraction is not an exemption.

8. Petitioner's burden of proof in the case at bar is a preponderance of the evidence.

9. A taxpayer must produce contemporaneous records and supporting documentation for the transactions in question to substantiate and enable verification of the taxpayer's claim related to the amount of tax, penalty, or interest to be assessed, collected, or refunded. *See* Texas Tax Code § 111.0041; 34 Tex. Admin. Code § 1.26(a).

10. In a suit for a refund, the taxpayer must show not only that it overpaid taxes, but also, the exact amount of the overpayment. *Nabors Drilling Techs. USA, Inc. v. Hegar* , 03-17-00284—CV, 2018 WL 2709201, at *5 (Tex. App–Austin June 6, 2018, pet. filed) (citing *Baker v. Bullock* , 529 S.W.2d 279 (Tex. Civ. App.—Austin 1975, writ ref'd n.r.e.)); *see also, e.g.* , Comptroller's Decision No. 114,611 (2019).

11. Summary schedules and assertions in pleadings are insufficient to meet the burden of proof. *See, e.g.,* Comptroller's Decision Nos. 115,376 (2020).

12. Franchise tax is imposed on each taxable entity that does business in this state or that is chartered or organized in this state. Tex. Tax Code § 171.001.

13. The taxable margin of a taxable entity is determined by calculating 70% of total revenue from the entity's total business, or by subtracting, at the election of the taxpayer, either COGS or compensation. Tex. Tax Code §§ 171.101(a)(1), .1011-.1013.

14. COGS includes all direct costs of acquiring or producing the taxpayer's goods, where "goods" are tangible personal property sold in the ordinary course of business of a taxable entity. *See* Tex. Tax Code § 171.1012(a)(1).

15. COGS includes the direct costs of acquiring or producing goods, including costs attributable to research, experimental, engineering, and design activities directly related to the production of the goods, including all research or experimental expenditures described by IRC Section 174. *See* Tex. Tax Code § 171.1012(c)(9).

16. A taxable entity may include in its costs of goods sold calculation the costs attributable to research, experimental, engineering, and design activities directly related to the production of the goods, including all research or experimental expenditures described by IRC § 174 *,* regardless of whether the taxable entity is the producer of the goods it sells. 34 Tex. Admin. Code § 3.588(d)(9).

17. A taxable entity may include in its COGS deduction research, experimental, engineering, and design activity costs, including all research or experimental expenditures described by Section 174 of the IRC, relating to goods it sells. *See* State Tax Automated Research (STAR) Accession No. 201504069L (April 24, 2015).

18. The term "qualified research" means research for which expenses may be treated as IRC 174 expenses. *See* 26 U.S. Code § 41(d).

19. The term research or experimental expenditures means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense." IRC Section 1.174-2(a)(1); *see also* STAR Accession No. 201504069L (April 24, 2015).

20. All costs incident to the development or improvement of a product are costs generally included in the term "research and experimental expenditures." *See* IRC Section 1.174-2(a)(1)-(2); *see also* STAR Accession No. 201504069L.

21. The sale or use of the product is not relevant to a determination of the eligibility of costs under Section 174. *See* Section 1.174-2(a)(1).

22. Expenditures for the research and development of a product that is for internal use or is otherwise incorporated into a taxable entity's business, and not sold, may qualify as research and experimental expenditures under IRC Section 174. *See* Section 1.174-2(a)(1).

23. Claimant failed to demonstrate the costs that remain at issue qualify as COGS under Section 171.1012(c)(9).

24. The partial refund denials should be affirmed.

SIGNED January 21, 2021.

TREVOR MOORE
ADMINISTRATIVE LAW JUDGE
STATE OFFICE OF ADMINISTRATIVE HEARINGS

ENDNOTES:

[1] The date calculated is 25 days after this decision is signed. *See* APA , Tex. Gov't Code § 2001.146(a) ; S.B. 1095 , Acts 2017, 85th Leg. For additional guidance, refer to the Frequently Asked Questions Related to Motions for Rehearing, found here: http://comptroller.texas.gov/taxes/publications/96-1789.pdf

[2] *Sunstate Equipment Company., LLC v. Hegar* , 601 SW 3d 685 (Tex. 2020), stating that "Chapter 171 makes clear that the COGS subtraction is not an exemption.

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