

Income/Franchise:

Texas Comptroller Addresses Cost of Goods Sold Deduction Pertaining to Research Expenses

Decision, Hearing Nos. 115,317, 115,318, 115,319, 115,320, 115,321, Tex. Comptroller of Public Accounts (2/3/21). In a recent Texas franchise tax hearing decision, an equipment manufacturing company claimed the cost of goods sold (COGS) deduction and included certain expenses that allegedly qualified as research expenses under Internal Revenue Code (IRC) section 174; an administrative law judge ultimately denied this portion of the COGS deduction based on a failure to adequately demonstrate that the research expenses related to goods sold by the company. In doing so, the judge explained that the company did not submit any additional evidence regarding the disputed costs – such as contemporaneous records and supporting documentation showing the costs were attributable to research, experimental, engineering, and/or design activity costs – and had conceded the accounts at issue likely included some costs that did not qualify for the COGS deduction.

URL: <https://star.comptroller.texas.gov/view/202102006H>

However, in a general sense, the judge concluded the following:

- 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, pursuant to Tex. Tax Code section 171.1012(c)(9);
- A taxable entity may include in its COGS 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 section 174, regardless of whether the taxable entity is the producer of the goods it sells, pursuant to 34 Tex. Admin. Code section 3.588(d)(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 IRC section 174, relating to goods it sells;
- 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,
- All costs incident to the development or improvement of a product are costs generally included in the term “research and experimental expenditures” under federal law;
- The sale or use of the product is not relevant to a determination of the eligibility of costs under IRC section 174; and
- 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.

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