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Texas Tax Update:

New R&D Law Simplifies and Conforms Credit to Federal Law What Taxpayers and Businesses Need to Know About Senate Bill 2206

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Texas just took a major step in reshaping how taxpayers performing research and development (R&D) activities claim franchise tax credit for R&D expenses.

Thanks to efforts championed by the Texas Taxpayers and Research Association (TTARA), the new R&D credit established by **Senate Bill 2206** greatly simplifies the franchise tax credit verification process for taxpayers and the Texas Comptroller alike.

The act is effective for reports due on or after January 1, 2026. The final version is available in its entirety here: [SB2206](#) (select “enrolled” version).

Here’s what this means for taxpayers who perform R&D activities:

1. Definition of “Qualified Research Expense” (QRE) is Tied to the Federal Income Tax Return.

Under the law currently in effect, “qualified research” has the meaning assigned by Section 41 of the Internal Revenue Code (IRC). The incorporation of IRC § 41 by reference ties “qualified research activities” to the criteria described in IRC §41(d), commonly known as the “Four-Part Test”.

The Comptroller has extensive rules identifying what constitutes qualified research under the Four-Part Test. See 34 Tex. Admin. Code 3.599(c). The Four-Part Test places a significant burden of proof on taxpayers to establish their entitlement to the R&D credit. Taxpayers are often required to produce voluminous and highly technical documentation (including potentially sensitive or confidential records) to prove that a process of experimentation occurred. The process of verifying the R&D credit has been arduous for

both taxpayers and auditors. Review of the R&D credit alone could cause an audit to continue for years before reaching a conclusion. Over the last few years, standalone R&D credit-based refund claims led to a backlog of unprocessed refund claims of epic proportions.

Comptroller auditors examining such documentation have varying degrees of technical expertise. Furthermore, the requirements of the Four-Part Test are highly qualitative. Concepts such as whether a taxpayer had “uncertainty” or engaged in a “process of experimentation” during the audit period are prone to subjective interpretation and application. A combination of these factors causes a degree of variance in the administration of the R&D credit, depending on an individual auditor’s application of his or her experience and taxpayer documentation to the Four-Part Test.

Under the new law, the definition of “qualified research” is no longer abstractly tied to IRC § 41. Instead, taxpayers may now claim credit based upon the amount of QREs reported on line 48 of IRS Form 6765 that are attributable to research conducted in Texas, with the caveat that amount entered on Form 6765 complies with federal law.

For the purposes of determining the amount on Form 6765, a taxpayer or the Comptroller may use statistical sampling procedures permitted by IRS Revenue Procedure 2011-42 or a successor publication issued by the IRS. The explicit inclusion of statistical sampling in the text of the act marks a significant departure from longstanding Comptroller policy, which has historically only utilized and endorsed non-statistical sampling.

QREs for supplies may not be excluded on the basis that the supplies are taxable, nontaxable, or exempted from taxation under Texas Tax Code Chapter 151.

If the IRS or the Comptroller determines that a taxpayer has met IRS requirements for recognizing QREs on their Accounting Standards Codification 730 financial statement, then the portion of those costs related to research in Texas is sufficient evidence of the taxpayer’s qualified research expenses for Texas franchise tax purposes.

By adhering to the federal R&D credit, the administration and verification of the Texas R&D credit is poised to become more streamlined. The substantial evidentiary burden associated with passing the Four-Part Test for Texas franchise tax purposes will likely be

greatly lessened or eliminated, and taxpayers will enjoy the efficiency of Texas borrowing from the IRS's extensive resources administering the credit.

2. Rolling Conformity with Federal Law

Under the current law, IRC § 41 was statutorily defined as the IRC 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. By applying a snapshot of federal law, Texas thereby incorporated a “fixed federal conformity” approach, rather than a “rolling conformity” approach that applies federal law as it evolves over time.

The lack of rolling conformity in the current iteration of the R&D credit presents significant challenges to taxpayers. Without rolling conformity, Texas taxpayers have been unable to utilize subsequent changes to the IRC that could result in more favorable or streamlined administration of the R&D credit. Furthermore, taxpayers were effectively forced to comply with two sets of R&D regulations, one for federal purposes and another for Texas.

Under the new law, the Texas franchise tax credit adheres to the federal law in effect for the tax year for which the corresponding federal income tax return was filed with the IRS.

The introduction of rolling conformity for the R&D credit introduces updates to the IRC, Treasury Regulations and Decisions, or other IRS guidance that has been released since the fixed conformity date of the prior law. For example:

- The IRS directive related to the verification of R&D credits for Large Business & International (LB&I) is intended to provide an efficient methodology for determining QREs. This directive is applicable to taxpayers who:
 - Have assets of at least \$10,000,000.
 - Follow U.S. GAAP to prepare their Certified Audited Financial Statements showing the amount of currently expensed R&D as 1) a separate line item on the income statement included in their Certified Audited Financial Statements, or 2) separately stated in a note to their Certified Audited Financial Statements.

- This Directive does not apply to any taxpayer unless the taxpayer uses these same U.S. GAAP financial statements to reconcile book income to federal tax income on Schedule M-3.
- The 2016 internal use software (IUS) regulations contained within Treasury Decision 9786. This decision narrows the definition of IUS, excludes software developed to allow interaction with third parties from the definition of IUS, and allows for partial safe harbor qualification of dual function software.

3. Increased Credit Amount

Under the current law, the Texas credit is computed at 5% (or 6.25% if the taxpayer incurs QREs under contract with one or more institutions of higher education) of the difference between the QREs incurred during the period on which the report is based, and 50% of the average amount of QREs incurred during the three preceding periods.

Under the new law, the calculation is still performed by comparing the QREs in the current period to 50% of the average amount from the three preceding periods. However, the rate of the credit increases to 8.722% (or 10.903% if QREs are incurred under a higher education contract).

Under the current law, if a taxpayer has no QREs in one or more of the three periods preceding the period on which the report is based, the credit is 2.5% of the QREs incurred during the period on which the report is based (or 3.125% if QREs are incurred under a higher education contract).

Under the new law, if a taxpayer has no QREs in one or more of the three preceding periods, the credit is 4.361% (or 5.451% if QREs are incurred under a higher education contract.)

4. Credit is Refundable for Certain Taxpayers

Under the current law, the total R&D credit claimed for franchise tax may not exceed 50% of the amount of franchise tax due before any other applicable tax credits. *See Texas Tax*

Code § 171.658. This language is still present under the new law; however, **Senate Bill 2206** establishes the R&D credit as refundable to certain taxpayers.

Under the new law, the 50% limitation does not apply to the following taxpayers:

- Taxpayers who owe no tax as a new veteran-owned business. *See* Texas Tax Code §§ 171.001(d) and 171.0005.
- Taxpayers who owe no tax due to having an amount of computed tax that is less than \$1,000. *See* Texas Tax Code § 171.002(d)(1).
- Taxpayers who owe no tax due to having an amount of total revenue less than or equal to the no tax due threshold for the 12-month period on which the report is based. *See* Texas Tax Code § 171.002(d)(2).

The addition of a refundable credit will provide tax benefit to taxpayers who otherwise would be unable to utilize the R&D credit. Under the prior law, businesses who owed no tax could establish an R&D carryforward, but may never be able to utilize it if they did not grow to a point where they owed franchise tax.

Under the new law, such businesses will be able to obtain the benefit of R&D credits for their QREs immediately. This move may promote innovation among the many burgeoning businesses in our State.

Taxpayers who do not qualify for the refundable credit and create credits that exceed the 50% limitation may carry forward their unused credit for 20 consecutive report periods.

5. Repeal of Prior Provisions

Senate Bill 2206 repeals the sales tax exemption contained in Texas Tax Code § 151.3182. The repeal of this section does not affect tax liability accruing before the effective date of the act. The liability continues in effect as if Section 151.3182 had not been repealed. The former law is continued in effect for the collection of taxes due.

Taxpayers who wish to derive tax benefit for depreciable tangible personal property should consider doing so through the Texas sales tax exemption prior to its repeal on 1/1/2026. Such property is not eligible for the franchise tax credit under the old or new law. IRC § 41(b)(2)(C) specifically excludes property of a character subject to depreciation from the definition of “supplies”. Since the new law requires that amounts entered on Form 6765 comply with federal law, depreciable TPP will be ineligible for the franchise tax credit.

Senate Bill 2206 also repeals the former franchise tax R&D law contained within Subchapter M of Chapter 171. The repeal of Subchapter M does not affect unused credits that taxpayers are authorized to carry forward. Taxpayers may continue to apply such carryforwards until the date the credit would have expired if Subchapter M had remained in effect. The former law under which a taxpayer accrued credits also continues to be in effect for the purpose of determining the amount of credits the taxpayer may claim and the manner in which they may claim the credits.

6. New Guidance for the Soon to be Old Credit

In March of this year, the Texas Comptroller issued two policy memos providing guidance on the franchise tax R&D credit and sales tax R&D exemption. While the old R&D laws on which these memos are based are soon to be repealed, the former laws will continue to be in effect for periods in which credits or exemptions were claimed. Therefore, these memos still contain valuable guidance that could be applied to periods audited by the Comptroller under the old law.

Comptroller Letter [202503003M](#) states that the definition of supplies in IRC § 41(b)(2)(C) excludes depreciable property, and that an expense being deductible under IRC § 174 does not affect that definition. Qualification as an IRC § 174 expense is a necessary condition for an expense to be a QRE. However, all other requirements of IRC § 41 must be met, including that the expense not be for depreciable property.

Comptroller Letter [202503004M](#) states that federal intra-group transaction rules do not apply when determining the R&D franchise tax credit or the sales tax exemption. For the federal R&D credit, members of a controlled group are treated as a single taxpayer. Conversely, Texas sales and use tax does not recognize the concept of combined reporting. While franchise tax combined groups are treated as a single taxpayer for the purpose of

determining the Texas R&D credit, the respective rules for determining Texas combined groups and federal controlled groups are fundamentally different. Therefore, the Comptroller stated that a federal “group under common control” is neither a single taxpayer for Texas franchise tax, nor sales tax purposes.

7. Impact on Existing Credit Claims

While the franchise tax credit contained within Chapter 171 Subchapter M, and the sales tax exemption contained in Texas Tax Code § 151.3182 will remain in effect for existing credit claims, it is possible that the passage of **Senate Bill 2206** will indirectly impact existing R&D claims and audits.

Verification of the R&D credit and exemption has placed a substantial administrative burden on the Audit Division and the Administrative Hearings Section of the Comptroller. It is not uncommon for an audit involving R&D to stretch on for years before it is completed, only to await a hearing for months or years.

As of June 13, 2025 there were 436 franchise tax cases in active hearings for audits covering periods on or after the effective date of Subchapter M (1/1/2014). Many of these cases likely involve R&D issues.

At the Comptroller’s 2024 Annual Briefing, Hearings and Tax Litigation General Counsel, Jim Arbogast stated that the division was working on reducing cases that have been pending for over two years. Tax Litigation Attorney, Bree Boyett, stated that the Comptroller was willing to consider settlement offers from taxpayers.

The Comptroller representatives’ actions have matched their statements. Even prior to the passage of **Senate Bill 2206**, they have shown that they have made settling R&D cases a priority.

Per the [Texas Tribune](#), there are approximately 515 auditors currently employed with the agency, down from a 5-year high of 589. Of the 515 auditors with the agency, 190 are Auditor I or II and are likely not handling audits with R&D. As of June 30, 2025, there

were 1,168 franchise tax audits in progress. These audits are assigned to only 72 unique auditors.

Therefore, the passage of **Senate Bill 2206** may cause the Comptroller to show further leniency in allowing or settling R&D credits taken in prior periods, favoring to spend the agency's audit resources elsewhere.

8. Senate Bill 2206 Fiscal Note

In the fiscal note accompanying **Senate Bill 2206**, the Legislative Budget Board presented an estimate prepared by the Comptroller of Public Accounts. The estimate is based on franchise taxpayer data for research and development credits, adjusted for the increased credit percent rates proposed by the bill and evaluated against the 50 percent of gross tax liability limit for each taxpayer on the amount of credit that may be claimed on a report. The estimate for 2026 and 2027 is net of the effects of repeal of the research and development sales tax exemption effective January 1, 2026 versus its expiration December 31, 2026 as provided by current law. The bill provides for carry forward of franchise tax credits accrued under the current Subchapter M before its repeal. Costs for this are not included in the estimated costs of the bill below because Subchapter M provides for the same carry forward after its expiration – i.e., the same costs for carry forward of Subchapter M credit accruals would be incurred whether this bill is enacted or not.

The negative impact is estimated to be up to (\$1,083,800,000) through the biennium ending August 31, 2029.

Based on the Comptroller's stated methodology, the estimate does not appear to account for additional taxpayers claiming the R&D credit, or for more R&D credits being upheld under **Senate Bill 2206's** more lenient structure. Fundamentally, this also fails to account for the possibility that the R&D credit achieves its goal of fostering increased R&D expenditures in Texas which would stimulate the State economy both directly and through indirect effects.

9. Conclusion and Impact on Future Periods

The Passage of **Senate Bill 2206** provides a significantly streamlined process for verification of franchise tax R&D credits, increases the rate of the credit, provides refundable credit to

certain taxpayers, creates rolling conformity with federal law, and repeals the R&D sales tax exemption.

For periods due on or after the effective date of the act, the Comptroller may transition to a predominantly quantitative review of the R&D credit, focusing on the portion of QREs attributable to Texas. Some qualitative review may be performed, such as determining that QREs are used in connection with research activities and verifying that QREs claimed are of a qualifying character. However, Texas taxpayers will likely no longer have to contend with the burdensome task of satisfying the Four-Part Test in the eyes of the Comptroller.

About Martens Law

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