Cause No. D-1-GN-21-006290

Ryan, LLC, Plaintiff,	§	In the District Court
v.	§	
Glenn Hegar, in His Official Capacity as Comptroller of Public Accounts of the State of Texas, and the Office of the Comptroller of Public Accounts for the State of Texas, Defendants.	§	of Travis County, Texas
	§	353rd Judicial District

Defendants' Response to Plaintiff's Motion for Summary Judgment

In its motion for summary judgment, Ryan, LLC tries to paint a picture of a Comptroller run amok, imposing requirements on taxpayers with little rhyme or reason. When it comes to substantiating its claims, though, Ryan's arguments are not colorable. Ryan applies inapplicable regulations, redefines words, confuses legal tests, and ignores precedent.

Out of this confusion, Ryan could score some major victories: excusing research and development from standard tax recordkeeping requirements and established evidentiary burdens, applying a tax break intended for research and development to ordinary production activities, and creating a government handout for brainstorming.

The Court should carefully analyze each of Ryan's arguments and dismiss Ryan's claims for lack of merit.

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STATUTORY BACKGROUND

For the Court's convenience, the primary statutory authority in this suit is provided below.

Incorporation of federal definitions into Texas law:

For the sales-tax exemption—Tex. Tax Code § 151.3182(a)(3):

> "Qualified research" has the meaning assigned by Section 41, Internal Revenue Code.

For the franchise-tax credit—Tex. Tax Code § 171.651(3):

> "Qualified research" has the meaning assigned by Section 41, Internal Revenue Code, except that the research must be conducted in this state.

Four Part Test for "qualified research"—26 U.S.C. § 41(d)(1):

> In general.--The term "qualified research" means research--
>
> (A) with respect to which expenditures may be treated as specified research or experimental expenditures under section 174,
>
> (B) which is undertaken for the purpose of discovering information--
>
> (i) which is technological in nature, and
>
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
>
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).
>
> Such term does not include any activity described in paragraph (4).

Exclusions from "qualified research"—26 U.S.C. § 41(d)(4):

The term "qualified research" shall not include any of the following:

(A) Research after commercial production.--Any research conducted after the beginning of commercial production of the business component.

(B) Adaptation of existing business components.--Any research related to the adaptation of an existing business component to a particular customer's requirement or need.

(C) Duplication of existing business component.--Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.

[etc.] * * *

EVIDENTIARY OBJECTIONS

Defendants' objections to Ryan's summary-judgment evidence were filed with this motion and are incorporated herein by reference.

ARGUMENT

I. Ryan is using flawed logic in an attempt to create tax loopholes.

Ryan's challenges to the Comptroller's R&D rules are fraught with mis-readings of both the governing law and the rules themselves.

Ryan begins by equating the federal section 174 deduction with the federal section 41 R&D credit as it tries to get around the fact that "manufacturing" is "commercial production." *See* Sections II–III. Ryan then ignores established precedent setting the burden of proof for tax exemptions and claims tantamount to exemptions as clear and convincing evidence. *See* Section IV. Ryan then attempts to

excuse R&D from standard tax recordkeeping by mischaracterizing a general tax requirement as a custom-made requirement for R&D. *See* Section V.

In a bid to broaden the statutes beyond their intended scope, Ryan declares that "technique" now means "design" and that a "process" is the same thing as a "service." *See* Section VI. Ryan then asks the Court to rule that brainstorming and shopping are processes of experimentation. *See* Sections VII, X. Defying logic, Ryan insists that a product is not "ready for commercial sale"—even after it has already been sold. *See* Section VIII. Ryan then confuses the Four Part Test for "qualified research" with *exclusions* from "qualified research" in order to make the peculiar argument that uncertainty prevents something from being an "adaption." *See* Section IX.

Ryan's position would disserve the legislative objective of making Texas "economically competitive in the field of research and development" by allowing R&D tax breaks for ordinary business activities and excusing businesses from standard tax recordkeeping. *See* Section XI. And Ryan's best effort to show that a retroactive application of the rules would be "harsh and oppressive" is to complain that it *might* not collect some of its fees that are *contingent* on the outcome of its clients' cases. *See* Section XII.

Pursuant to the principles of logic and the objectives of the Legislature, the Court should uphold the disputed[1] portions of the Comptroller's R&D rules.

[1] Having filed proposed amendments to 34 Tex. Admin. Code sections 3.340(a)(6), 3.599(b)(5), and 3.599(d)(5) with the Secretary of State, the Comptroller will not defend Ryan, LLC's challenges to those portions of the rules. *See* 47 Tex. Reg. 3425, 3434 (proposing amendments). While not defending those sections, the Comptroller does not concede that the sections are invalid, does not accept Ryan's

II. The manufacturing exemption and the sale-for-resale exemption are incompatible with the R&D franchise-tax credit.

As explained in the Comptroller's motion beginning at page 24, for an item to qualify for the sales-tax exemption for the purchase of items used in manufacturing, the taxpayer must use the items "in or during the actual manufacturing, processing, or fabricating of tangible personal property for ultimate sale." 46 Tex. Reg. at 7062; *see* Tex. Tax Code § 151.318 (providing manufacturing exemption); 34 Tex. Admin. Code § 3.599(b)(8)(A)(iii)(I)(-a-) (explaining incompatibility of the exemption with the R&D credit). Thus, when a taxpayer claims the exemption on an item, the taxpayer is informing the Comptroller that it is using the item in commercial production. The taxpayer cannot then make an about-face and claim that its use of the item was for research that was not a part of commercial production.

Similarly, the sale-for-resale exemption, which requires that items be purchased for resale, is inconsistent with the claim that an item was purchased for research. *See* Tex. Tax Code § 151.006 (providing sale-for-resale exemption); 34 Tex. Admin. Code § 3.599(b)(8)(A)(iii)(I)(-a-) (explaining incompatibility of the exemption with the R&D credit).

Ryan presents three lines of argument that taking the manufacturing exemption or the sale-for-resale exemption does not prevent a taxpayer from including those expenses in the calculation of the R&D franchise-tax credit despite the incompatibility of those exemptions with R&D activities.

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arguments regarding the sections, and does not accept what Ryan claims are the consequences of the sections' invalidity.

First, Ryan submits that two sentences of Treasury Regulation 1.174-2(a)(1) apply to a taxpayer's calculation of the franchise-tax credit, but they do not. MSJ at 32. Ryan argues that the sentence "Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated" means that those costs may also be included the calculation of the R&D franchise-tax credit.

But that sentence applies only to *costs* that can be deducted *under section 174*, not costs that may be credited as R&D. Section 174 of the Internal Revenue Code is only relevant to the R&D franchise-tax credit to the extent it describes the *activities* that qualify for a section 174 deduction. *See* 26 U.S.C. § 41(d)(1)(A) (providing Section 174 Test for the types of research activities that constitute "qualified research").

While the types of activities that qualify for a section 174 deduction are relevant to the R&D franchise-tax credit, the specific costs allowed by section 174 are not. Expenses deducted under section 174 are different from expenses used to calculate an R&D credit. And even if an activity is of the type described by section 174, it may still be excluded from R&D as "research conducted after the beginning of commercial production of the business component." 26 U.S.C. § 41(d)(4)(A) (providing exclusion from "qualified research"). Thus, this sentence of Treasury Regulation 1.174-2(a)(1) is inapplicable to the R&D franchise-tax credit.

Ryan also quotes Treasury Regulation 1.174-2(a)(1) for the proposition that the "ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174." But Ryan's argument equates to replacing "under

section 174" with "under section 41," the section of the Internal Revenue Code that provides for the federal R&D credit. Under section 41, though, "[a]ny research conducted after the beginning of commercial production of the business component" is not "qualified research" for which a tax credit may be taken. 26 U.S.C. § 41(d)(4)(A). Thus, Ryan's application of Treasury Regulation 1.174-2(a)(1) conflicts with the language of the R&D statutes.

Ryan then posits that the provision in the manufacturing-exemption statute that excludes from the exemption "equipment or supplies used in . . . research or development of *new* products" does not apply to products that are *improved* through research and development. MSJ at 33–34. But that distinction does not matter because the R&D statutes themselves exclude research conducted after the beginning of commercial production from the calculation of the R&D credit. *See* 26 U.S.C. § 41(d)(4)(A) (excluding research after commercial production from "qualified research").

In other words, it is not the manufacturing-exemption statute but rather the R&D statutes that prevent a taxpayer from taking the manufacturing exemption on expenses credited as R&D. Ryan is mistaken in this regard.

Finally, Ryan points to the fact that the only exemption specifically named by the R&D statutes that cannot be taken concurrently with the R&D franchise-tax credit is the R&D sales-tax exemption. But this stands to reason because a transaction could simultaneously qualify for both the R&D franchise-tax credit and the R&D sales-tax exemption. In the cases of the manufacturing exemption and the

sale-for-resale exemption, though, a transaction simply *cannot* simultaneously qualify for either of the exemptions and the R&D franchise-tax credit. There is no need to state that the R&D credit cannot be taken concurrently because the provisions cannot be concurrently applied to the same transaction.

III. Research for which a taxpayer is claiming the manufacturing exemption is "research after commercial production."

Ryan's only argument that research for which a taxpayer is claiming the manufacturing exemption is *not* "research after commercial production" depends on the "cost" sentence from Treasury Regulation 1.174-2(a)(1), which, as discussed above in section II, does not apply to the R&D tax breaks. *See* 34 Tex. Admin. Code §§ 3.340(d)(1)(B)(vii), 3.599(d)(1)(B)(vii) (explaining that activities for which a taxpayer is taking the manufacturing exemption are excluded from "qualified research" as "research after commercial production").

Another indication that the "cost" sentence from Treasury Regulation 1.174-2(a)(1) is inapplicable to the R&D tax breaks is that it conflicts with the exclusion from "qualified research" of research after commercial production. *See* 26 U.S.C. § 41(d)(4)(A) (excluding research after commercial production from "qualified research"). This conflict is resolved by the fact that the "cost" sentence applies to the federal section 174 deduction while the research-after-commercial-production exclusion applies to the federal R&D credit.

IV. In civil suits, the burden of proof for tax exemptions and claims tantamount to exemptions is clear and convincing evidence.

Ryan assumes that the burden of proof in all tax protest and refund suits is preponderance of the evidence, MSJ at 59, but that simply is not true. In a tax protest

or refund suit in which a taxpayer argues that it can avail itself of a tax exemption or a tax break "tantamount" to an exemption, the taxpayer's burden of proof is clear and convincing evidence. *Sw. Royalties, Inc. v. Hegar*, 500 S.W.3d 400, 404 (Tex. 2016); *Bullock v. Nat'l Bancshares Corp. of Tex.*, 584 S.W.2d 268, 271 (Tex. 1979); 34 Tex. Admin. Code §§ 1.26(c), 3.340(b)(6), 3.599(e)(2). Ryan's reliance on *U.S. Concrete v. Hegar* is misplaced since that case acknowledges the special burden of proof for tax exemptions. *See* 578 S.W.3d 559, 571 (Tex. App.—Austin 2019, pet. denied) ("[T]axpayers must clearly show entitlement to an exemption.").

That the trial court must "try each issue of fact and law in the manner that applies to other civil suits in this state as though there had not been an intervening agency action or decision," Tex. Gov't Code § 2001.173(a), is simply an explanation of trial de novo and does not speak to the burden of proof borne by the taxpayer.

In fact, the "trial de novo" standard on which tax-protest and refund claims are reviewed in district court is "a new and independent action characterized by all the attributes of an original civil action." *Atty. Gen. of Tex. v. Orr*, 989 S.W.2d 464, 467 (Tex. App.—Austin 1999, no pet.). And in civil actions, the taxpayer must demonstrate that it is entitled to a tax exemption or tax break "tantamount" to an exemption by clear and convincing evidence. *Sw. Royalties, Inc.*, 500 S.W.3d at 404; *Nat'l Bancshares Corp. of Tex.*, 584 S.W.2d at 271; 34 Tex. Admin. Code § 1.26(c).

V. R&D should not be excused from standard tax recordkeeping requirements.

Ryan begins its attack on standard tax recordkeeping requirements by arguing that the "amount of tax" has nothing to do with the elements needed to establish that

amount. MSJ at 63. Ryan correctly notes the general principle that taxpayers are "required to produce and maintain records to enable verification of [their] claim[s] relating to the amount of the tax that will be refunded." *U.S. Concrete*, 578 S.W.3d at 569 (citing Tax Code § 111.0041). The amount of the tax, though, is determined by the elements of the tax.

For example, in the R&D context, a taxpayer must, among other things, pass all four parts of the Four Part Test for "qualified research" in order to receive a tax break. *See* 26 U.S.C. § 41(d)(1) (providing Four Part Test). If a taxpayer has no documentation to show that it meets the elements of the Four Part Test, the taxpayer cannot get a tax break for R&D activities.

In order to produce and maintain records supporting "the *amount* of tax," Tex. Tax Code § 111.0041(c) (emphasis added), a taxpayer must produce and maintain records related to *each element* of the tax it seeks to recover. The amount is determined by establishing the elements.

Ryan then posits that the Internal Revenue Service considered and rejected a similar recordkeeping requirement for the federal R&D tax credit. MSJ at 63–64. But what the IRS actually did was reject a special recordkeeping requirement for R&D in favor of applying only the standard tax recordkeeping requirements—which is what the Texas R&D rules do. *See* 34 Tex. Admin. Code §§ 3.340(b)(6), 3.599(e)(2)(B) (applying Tax Code section 111.0041 in the R&D context).

When the IRS was making its rules to implement the federal R&D tax credit, it considered requiring taxpayers to "prepare and retain written documentation

before or during the early stages of the research project that describes the principal questions to be answered and the information the taxpayer seeks to obtain that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering." 66 Fed. Reg. 280, 284 (2001).

As Ryan notes, the IRS later rejected this "research credit-specific documentation requirement" and decided instead to use the "generally applicable" rules for documentation and substantiation of taxes. MSJ at 64. Texas's R&D rules do the same by reminding taxpayers of Tax Code section 111.0041's general tax recordkeeping requirements. *See* Tex. Tax Code § 111.0041(d) ("This section prevails over any other conflicting provision of this title."); 34 Tex. Admin. Code §§ 3.340(b)(6), 3.599(e)(2)(B) (applying Tax Code section 111.0041 in the R&D context).

In a final effort, Ryan turns to statements by one of its Directors.[2] The Ryan Director states that some taxpayers "have no independent business need to maintain the types of records identified in the rule amendments." Thompson Aff. ¶ 57. There are several problems with this statement that make it misleading.

First, while a business might not need to "maintain" records, any business conducting R&D will *create* records in the ordinary course. Second, while there may not be an "independent business need" to maintain records, there is the general need to maintain records for tax purposes regardless of whether a business wishes to receive an R&D tax break. *See* Tex. Tax Code §§ 111.0041(a) (requiring maintenance of tax records for four years), (c) (requiring production of contemporaneous records to

[2] The Comptroller is objecting to the consideration of these statements on the grounds that they are irrelevant, confuse the issues, and are conclusory.

substantiate tax claims), 111.201 (providing general four-year statute of limitations for tax assessments).

Third, the "types of records identified in the rule amendments" are simply examples provided for taxpayers' convenience and are not an exhaustive list. *See, e.g.*, 34 Tex. Admin. Code § 3.599(e)(2)(B)(i) ("This includes, *but is not limited to*, payroll records, employee job descriptions, performance evaluations, calendars, and appointment books.") (emphasis added). So a business would not need to keep the "types of records identified in the rule amendments." *See* Thompson Aff. ¶ 57.

The Ryan Director also states that "businesses will need to create the records described in the Amended Rules in order to comply." Thompson Aff. ¶ 58. This sentence is also misleading.

While it is true that a business will need to create records in order to substantiate its entitlement to an R&D tax break, it is also the case that a business will almost certainly create those records anyway. And, once again, because the list of records described in the R&D rules is not exhaustive, a business can use other types of records specific to its work to comply. *See, e.g.*, 34 Tex. Admin. Code § 3.599(e)(2)(B)(ii) ("This includes, *but is not limited to*, inventory records, invoices, purchase orders, and contracts.") (emphasis added).

Because the R&D rules do nothing more than apply the general tax recordkeeping requirements in the context of R&D, Ryan's arguments fall short.

VI. "Technique" does not mean "design," and "process" does not mean "service."

To argue that services and designs are "business components," Ryan states, as though it were obvious, that "design" falls under the definition of "technique" and that "service" falls under the definition of "process." MSJ at 68 (addressing 34 Tex. Admin. Code. sections 3.340(c)(1)(C)(i)–(ii) and 3.599(c)(1)(C)(i)–(ii)). This argument is contrary to "plain meaning" and "ordinary usage." *See Albertson's Inc. v. Sinclair*, 984 S.W.2d 958, 960 (Tex. 1999) (beginning statutory interpretation "by looking to the statute's plain and common meaning").

No one would ever say, "This is the technique of my new house" when they were really talking about the *design* of the house. Likewise, a person would never thank someone for their many years of "process" when they really meant *service*.

Ryan also states that the "Comptroller's determination that designs and services are not business components is not supported by the legislative history to Internal Revenue Code Section 41, case law, or administrative guidance." MSJ at 67. But these assertions are unsupported by argument.

VII. Brainstorming is not research and development.

Ryan argues that "[n]on-experimental methods, such as simple trial and error, brainstorming, or reverse engineering" should be eligible for the R&D tax breaks because those terms are not found in the rules' governing statutes. MSJ at 70 (addressing 34 Tex. Admin. Code section 3.340(c)(1)(D)(v) and 3.599(c)(1)(D)(v)). But Ryan is using a negative to prove a positive. Teaching swimming lessons is also an

activity that is not eligible for an R&D tax break even though the words "swimming lessons" do not appear in the R&D statutes.

The R&D statutes describe what *is* tax-favored R&D while leaving mostly unsaid what is *not*. This stands to reason: the set of activities that qualify for the R&D tax breaks is vastly smaller than the set of activities that do not. The Comptroller's rules simply give taxpayers a hand by pointing out some activities that could be misinterpreted as R&D but in fact are not.

The requirements in the R&D statutes are specific enough to prohibit tax breaks for brainstorming and simple trial and error. *See* 26 U.S.C. § 41(d)(1) (providing test for "qualified research"). Moreover, the R&D statutes explicitly exclude reverse engineering from the definition of "qualified research." *See* 26 U.S.C. § 41(d)(4)(C) (excluding "research related to the reproduction of an existing business component . . . from a physical examination of the business component"). And it should go without saying that a "non-experimental method" is not a "process of experimentation." *See* 26 U.S.C. § 41(d)(1)(C) (providing "process of experimentation" requirement).

Having exhausted its arguments regarding subsection (c)(1)(D)(v), Ryan turns to subsection (c)(1)(D)(vi), a portion of the rules that it has not challenged in this suit. MSJ at 70. Because it has not challenged subsection (c)(1)(D)(vi), its arguments attacking that subsection are irrelevant.[3]

[3] Ryan reads subsection (c)(1)(D)(vi) as imposing "recordkeeping requirements." MSJ at 71. But subsection (c)(1)(D)(vi) simply lists factors that the Comptroller may—or may not—consider when determining whether trial and error is systematic (eligible for R&D tax break) or simple (not eligible). 34 Tex. Admin. Code §§ 3.340(c)(1)(D)(vi), 3.599(c)(1)(D)(vi). A taxpayer is not required to submit any

VIII. A product that has already been sold is "ready for commercial sale."

Ryan's only argument that the Comptroller's example involving computer chips is invalid is that an acceptable product that has been ordered for delivery is somehow not "ready for commercial sale or use" and does not "meet[] the basic functional and economic requirements of the taxpayer for the component's sale or use." MSJ at 73 (addressing 34 Tex. Admin. Code sections 3.340(d)(1)(E)(iii) and 3.599(d)(1)(E)(iii)).

It is difficult to understand where Ryan is coming from because by the time an acceptable product is developed and a delivery of that product has been ordered, the product is doubtlessly "ready for commercial sale." In fact, the product has already been sold. And it should go without saying that the product also "meets the basic functional and economic requirements of the taxpayer for the component's sale or use" because the taxpayer has already sold it.

IX. Uncertainty has nothing to do with whether something is an adaptation.

Ryan challenges the Comptroller's oil-and-gas example in subsection (d)(2)(F). MSJ at 74. That example illustrates the fine distinction between (1) a business component that is "intended for a specific customer," which can qualify for a tax break, and (2) "adapting an existing business component to a particular customer's requirement or need," which does not. 26 C.F.R. § 1.41-4(c)(3); 34 Tex. Admin. Code §§ 3.340(d)(2), 3.599(d)(2). While both apply to work done for a specific customer, the

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of the documents referred to in the subsection. Also, the subsection contains *factors* not elements: the factors do not amount to requirements, and the Comptroller will not apply them in every case.

difference between the two is that the second one involves *adapting* a business component that *already exists*.[4]

As an example of this second scenario, the Comptroller describes an oil-and-gas operator who "drilled several horizontal wells before its customer was satisfied with the economic results" and "modified its existing horizontal drilling program as a result." 34 Tex. Admin. Code §§ 3.340(d)(2)(F), 3.599(d)(2)(F).

Ryan nevertheless insists that the operator's modification of "its existing horizonal drilling program" to satisfy its customer's economic demands is not "adapting an existing business component to a particular customer's requirement or need" because there is too much "uncertainty." MSJ at 75. That argument, however, exhibits a misunderstanding of the Four Part Test and the exclusions from "qualified research."

Uncertainty is needed to satisfy the Section 174 Test, the Discovering Technological Information Test, and the Process of Experimentation Test. *See* 26 C.F.R. §§ 1.41-4(a)(3) (addressing "uncertainty"), 1.41-4(a)(5) (same), 1.174-2(a)(1) (same). The Comptroller's example, however, is about the *exclusion* from "qualified research" for adaptations of existing business components that applies even when a taxpayer passes the Section 174 Test, the Discovering Technological Information Test, and the Process of Experimentation Test. *See* 26 U.S.C. § 41(d)(4)(B) (providing exclusion). In the Comptroller's example, then, it does not matter whether or not the

[4] Ryan quotes the Comptroller's *proposed* rule and suggests that the adopted rule still says what the proposed rule said. MSJ at 75–76. But the Comptroller changed the adopted rule to reflect the distinction discussed in the paragraph above.

oil-and-gas operator has dealt with uncertainty and passed any parts of the Four Part Test. The point is that—even if the taxpayer were to pass the Four Part Test—the taxpayer's activities are excluded from "qualified research" because the taxpayer was "adapting an existing business component to a particular customer's requirement or need."

Ryan cites a statement from the IRS suggesting that the exclusion from "qualified research" for adapting an existing business component to a particular customer's requirement or need is inapplicable if a taxpayer passes the Four Part Test. MSJ at 76. But that would make this exclusion superfluous. Again, the way that the R&D statutes work is that a taxpayer must first pass the Four Part Test and then determine whether its activities are otherwise excluded from "qualified research." *See* 26 U.S.C. §§ 41(d)(1) (providing Four Part Test for "qualified research"), (d)(4) (providing exclusions from "qualified research"). Adapting an existing business component to a particular customer's requirement or need is one of those exclusions, and Congress would not have placed the exclusion in the statute if Congress did not intend to exclude those activities from tax-favored R&D. *See First Am. Title Ins. Co. v. Combs*, 258 S.W.3d 627, 631–32 (Tex. 2008) ("[O]rdinarily, when divining legislative intent, the truest manifestation of what lawmakers intended is what they enacted.") (quotation marks omitted).

Moreover, Ryan itself acknowledges this fact when it concedes that "[a]mended Rules 3.340(d)(2) and 3.599(d)(2) accurately describe the rule that research related to

adapting an existing business component to a particular customer's requirement or need does not constitute 'qualified research.'" MSJ at 74.

Returning to the oil-and-gas example, Ryan concludes by arguing that the adaptation was made not for the customer's need but rather for the taxpayer's because the taxpayer drilled the well. But the taxpayer would not have drilled the well unless it was paid by the customer to do so. This was a service for a particular customer, and as such, the customer's needs dictated the taxpayer's drilling efforts. Under Ryan's reasoning, an adaption would *never* be for a customer's requirement or need.

X. Shopping and ordinary production activities are not processes of experimentation.

Ryan argues that the Comptroller's oil-and-gas examples regarding the Process of Experimentation Test are invalid because, according to Ryan, the examples stand for the proposition that "if a taxpayer *uses* commercially available or its existing technology, then that taxpayer has not engaged in a process of experimentation." MSJ at 79 (emphasis added). But that is not what the examples illustrate.

The point of one of the examples (Example 7) is that "evaluating commercially available options does not constitute a process of experimentation." 34 Tex. Admin. Code §§ 3.340(c)(1)(D)(vii)(VII), 3.599(c)(1)(D)(vii)(VII). In other words, shopping for technology is not experimentation. In response to Ryan's contention about using technology, if the taxpayer were to go on to *use* the technology in a process of experimentation, the taxpayer could qualify for an R&D tax break. But the example

does not go that far: it stops when the taxpayer is done shopping. Thus, Ryan's characterization of the example is incorrect and misleading.

The other example (Example 8) draws the line between experimenting with drilling methods and simply engaging in business as usual. In that example, the oil-and-gas operator encounters a new geologic formation and uses its existing technology to drill into it. 34 Tex. Admin. Code §§ 3.340(c)(1)(D)(vii)(VIII), 3.599(c)(1)(D)(vii)(VIII). The existing technology is successful, and the operator does not perform any experimentation to evaluate any alternative drilling methods. *Id.* Returning to Ryan's argument, it is true that the operator *used* a business component—its drilling process—but the point is that the operator did not engage in a process of experimentation because the operator did not evaluate any alternative drilling methods. Once again, Ryan has mischaracterized the example provided in the rules.

Ryan also makes arguments regarding the Discovering Technological Information Test, but the examples Ryan is challenging here illustrate the Process of Experimentation Test, not the Discovering Technological Information Test. MSJ 79–80. Whether a taxpayer passes one has no bearing on whether it passes the other: a taxpayer must pass both of these tests independently to qualify for an R&D tax break. *See* 26 U.S.C. § 41(d)(1) (providing Four Part Test for "qualified research").[5]

[5] Ryan's motion mentions 34 Tex. Admin. Code sections 3.340(c)(1)(D)(vii)(IX) and 3.599(c)(1)(D)(vii)(IX), but those sections are not challenged in Ryan's live pleading. Nor were the sections argued in Ryan's Original Petition.

XI. Making Texas economically competitive in the field of research and development requires setting standards.

Ryan complains that the Comptroller's rules make qualifying for the R&D tax breaks "more difficult." MSJ at 80. But the Legislature's objective with the R&D statutes was not to hand out as much tax revenue as possible but rather to "make Texas economically competitive in the field of research and development." Act of May 21, 2013 § 1(b)(1). That goal is unachievable without setting standards.

Take Harvard, one of the most competitive universities in the world. What makes it competitive are its standards for admission. If Harvard lowered its standards and let more people attend, it would lose its competitive advantage. So, too, with Texas and R&D: if ordinary business activities qualified as R&D, businesses would have no tax incentive to innovate and attract the best scientists and engineers to Texas.

And the Comptroller cannot simply take taxpayers' word that they are engaging in R&D activities. Proof in the form of contemporary documentation is necessary—as it is for all taxes. *See* Tex. Tax Code § 111.0041(c) (providing tax documentation requirement).

Nor should the Comptroller be expected to accept fuzzy math: because the R&D tax breaks exempt taxpayers from taxes they would otherwise owe, clear and convincing evidence is required. *See Nat'l Bancshares Corp.*, 584 S.W.2d at 271–72 ("Statutory exemptions from taxation are subject to strict construction since they are the antithesis of equality and uniformity and because they place a greater burden on other taxpaying businesses and individuals.").

These evidentiary requirements ensure that the R&D tax breaks go to businesses that are actually engaging in R&D in order to fulfill the statutes' purposes.

XII. The Comptroller's rules do not change the law: they assist taxpayers with tax reporting.

Ryan faults the Comptroller for applying the R&D rules retroactively to taxes beginning January 1, 2014. But this application makes sense: because the R&D rules implement statutes that went into effect on January 1, 2014, the rules themselves are effective for taxes beginning on that date. 34 Tex. Admin. Code §§ 3.340(i)(1), 3.599(a)(1).

This principle is illustrated in *Sharp v. Park 'N Fly of Texas, Inc.*, 969 S.W.2d 572 (Tex. App.—Austin 1998, pet. denied). There, the Comptroller promulgated a rule that "became effective in 1995 and was made applicable as of October 1993." *Id.* at 578. The Austin Court of Appeals held that the rule was "not unconstitutionally retroactive" because the rule was a "proper construction" of a tax statute that went into effect in October 1993.

While the rules may *apply* retroactively, the rules do not *change the law* retroactively. The Comptroller's R&D rules simply implement the R&D statutes, providing guidance to taxpayers about when they may take the tax breaks. *See* Tex. Tax Code §§ 111.002(a) ("The comptroller may adopt rules that do not conflict with the laws of this state . . . for the enforcement of the provisions of this title."), 171.662 ("The comptroller shall adopt rules and forms necessary to implement [the R&D franchise-tax credit].").

If any portion of the rules did change the law, it would be invalid. *See Tex. Bd. of Chiropractic Exam'rs v. Tex. Med. Ass'n*, 616 S.W.3d 558, 568 (Tex. 2021) (explaining that an agency rule must be "consistent with the meaning of the terms in the Act"). Because the rules do not—and cannot—change the law, they are not retroactive changes in the law.

The R&D *statutes* are the source of the law that taxpayers must follow, and taxpayers have been on notice of those statutes since they were enacted in May 2013, well before they went into effect in January 2014. *See* Act of May 21, 2013 § 7 (providing effective date).

To the extent the rules have any "impact" on taxpayers, the impact is that more taxpayers will get their taxes right the first time: they can now read the Comptroller's rules and make a more accurate determination of the amount of taxes due. A good-faith effort at reporting taxes will now include reading the Comptroller's rules whereas before all taxpayers had was the statutes. Errors in tax reporting related to the R&D tax breaks that might have been excusable before the rules were promulgated are now less likely to be excused. *See* Tex. Tax Code § 111.103(a) (allowing the Comptroller to waive penalty or interest when a taxpayer "exercised reasonable diligence to comply" with state tax requirements).

The Comptroller's modifications to the rules during the notice and comment period were simply adjustments to align the rules with current policy. The feedback from taxpayers on the proposed rules showed the Comptroller how the proposed rules

were not consistent with current policy, and the Comptroller modified the rules as a result.

Ryan's due-process argument is that the retroactive application of the R&D rules is "so harsh and oppressive as to transgress . . . constitutional limitation[s]" because Ryan will be less likely to collect some of its contingency fees and because Ryan qualified for the franchise-tax credit for software it developed, but, one must infer, no longer qualifies. Ryan's argument presumes too much.

First, a contingency fee is a fee that is contingent upon the outcome of a suit or engagement: it is not a guaranteed fee. Ryan's argument treats its continency fees as guaranteed fees.

Second, while Ryan claimed the R&D franchise-tax credit on its development of software, no independent authority (such as a court or the Comptroller) has evaluated whether Ryan's development activities qualify for the credit. Ryan can say that its activities qualify for a tax break, but that does not make it so.

XIII. Ryan has not stated a claim for an injunction.

In its motion for summary judgment, Ryan argues that the Court has *jurisdiction* to enter an injunction prohibiting the Comptroller from enforcing any portion of the R&D rules that the Court rules are invalid. MSJ at 12–13. But Ryan has submitted no argument or evidence on the *merits* or elements of an injunction.

Nor has Ryan pled or applied for an injunction in its petition. Ryan makes the bare statement that it "seeks a declaration that . . . the Comptroller is enjoined from enforcing those subsections." 1st Am. Pet. ¶ 9. In its Prayer, Ryan requests that the "Court enter a judgment . . . enjoining the Comptroller from enforcing those

subsections." But that is all Ryan's petition contains regarding an injunction: no elements, no legal argument, and no factual allegations that would entitle it to the relief it purportedly seeks. *See Pike v. Tex. EMC Mgmt., LLC*, 610 S.W.3d 763, 792 (Tex. 2020) ("To be entitled to a permanent injunction, a party must prove (1) a wrongful act, (2) imminent harm, (3) an irreparable injury, and (4) the absence of an adequate remedy at law.").

And the statute under which Ryan is seeking declaratory relief does not entitle Ryan to an automatic injunction if Ryan prevails on the substance of its claims. *See* Tex. Gov't Code § 2001.038 (providing for declaratory relief only).

Because Ryan has not pled, applied for, or properly moved for an injunction, the Court should not grant one.

PRAYER

Defendants Glenn Hegar, in his official capacity as Comptroller of Public Accounts of the State of Texas, and the Office of the Comptroller of Public Accounts for the State of Texas ask the Court to declare the disputed portions of sections 3.340 and 3.599 of volume 34 of the Texas Administrative Code valid.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on the 17th day of June, 2022 a true and correct copy of the foregoing was served on all parties and counsel of record listed below via e-service and/or electronic mail:

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Cause No. D-1-GN-21-006290

Ryan, LLC, Plaintiff, v.	§ § § §	In the District Court
Glenn Hegar, in His Official Capacity as Comptroller of Public Accounts of the State of Texas, and the Office of the Comptroller of Public Accounts for the State of Texas, Defendants.	§ § § § §	of Travis County, Texas 353rd Judicial District

Final Judgment on Cross Motions for Summary Judgment

On July 18, 2022, the motions for summary judgment of Plaintiff, Ryan, LLC, and Defendants, Glenn Hegar, in his official capacity as Comptroller of Public Accounts of the State of Texas, and the Office of the Comptroller of Public Accounts for the State of Texas, were heard by the Court. All parties appeared and announced ready.

Having considered the pleadings, motions, evidence, and arguments of counsel, the Court rules on Plaintiff's claims as follows:

Section(s)	Description	Ruling
3.340(a)(6) 3.599(b)(5)	Providing definition of "Internal Revenue Code"	
3.340(c)(1)(C)(i) 3.599(c)(1)(C)(i)	Explaining that a service is not a "business component"	
3.340(c)(1)(C)(ii) 3.599(c)(1)(C)(ii)	Explaining that a design is not a "business component"	
3.340(c)(1)(D)(vii)(VII) 3.599(c)(1)(D)(vii)(VII)	Example illustrating that evaluating commercially available options is not a "process of experimentation"	
3.340(c)(1)(D)(vii)(VIII) 3.599(c)(1)(D)(vii)(VIII)	Example illustrating that using existing technology, by itself, is not a "process of experimentation"	

3.340(c)(1)(D)(v) 3.599(c)(1)(D)(v)	Explaining that non-experimental methods such as brainstorming are not considered a "process of experimentation"	
3.340(d)(2)(F) 3.599(d)(2)(F)	Example illustrating drilling activities that are "related to the adaption of an existing business component to a particular customer's requirement or need"	
3.340(d)(1)(B)(vii) 3.599(d)(1)(B)(vii)	Explaining that a taxpayer cannot take the manufacturing exemption concurrently with an R&D tax break	
3.340(d)(1)(E)(iii) 3.599(d)(1)(E)(iii)	Example illustrating that research conducted after a product is sold is "research conducted after the beginning of commercial production"	
3.599(d)(5)	Providing definition of "internal use software"	
3.340(b)(6), first sentence 3.599(e)(2), not including subsections (A) or (B)	Explaining that the burden of proof for the R&D tax breaks is clear and convincing evidence	
3.340(b)(6), second sentence 3.599(e)(2)(B)	Explaining that the R&D tax breaks must be supported by contemporaneous business records	
3.340(i)(1) 3.599(a)(1)	Providing effective dates	
3.599(b)(8)(A)(iii)(I)(-a-)	Explaining that the manufacturing exemption and the sale-for-resale exemption are incompatible with the R&D franchise-tax credit	

The Court rules on Defendants' objections as follows:

Exhibit #	**Objection(s)**	**Ruling**
2	Irrelevant, confuses the issues	
5	Irrelevant, confuses the issues	
15	Irrelevant, confuses the issues, conclusory	
16	Irrelevant, confuses the issues	
17	Irrelevant, confuses the issues	

18	Hearsay, irrelevant, confuses the issues, complete lack of authentication	
19 ¶¶ 26–35	Irrelevant, confuses the issues	
19 ¶¶ 36–37	Irrelevant, confuses the issues, conclusory	
19 ¶¶ 44–51	Irrelevant, confuses the issues, conclusory	
19 ¶¶ 56–69	Irrelevant, confuses the issues, conclusory	
19 (Exhibit C)	Irrelevant, confuses the issues	

All costs of court are borne by the party incurring same. All relief requested and not granted herein is DENIED. This order is final and disposes of all parties and claims.

SIGNED on _____, 2022.

_____
THE HONORABLE KARIN CRUMP
Judge Presiding

APPROVED AS TO FORM:

_____
Brittney Johnston
Counsel for Defendants

_____
Doug Sigel
Counsel for Plaintiff

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