

Incentives Lost: How Misconceptions about the R&D Tax Credit are Costing Businesses Thousands

2016

Background on the R&D Tax Credit

In 1981, the Research and Development Tax Credit was enacted as a temporary credit. The Credit has almost always been extended year to year, sometimes for a few years at a time. Historically, taxpayer's ability to take advantage of the credit has been limited by uncertainty regarding the extension of the credit and its AMT limits.

On Friday, December 18th, the U.S. Senate passed an Omnibus bill that included the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), H.R. 2029. Thereafter, President Obama signed the bill into law. For the first time, the Credit for Increasing Research Activities (The R&D Credit) is permanent. The major changes to the R&D credit are as follows:

The credit has become permanent and retroactive to 01/01/15.

By making the credit permanent, the R&D Credit will become a benefit that companies can incorporate into their financial and tax planning.

Credit Can Reduce AMT for Eligible Small Businesses starting in 2016.

- Credit eligible to offset Alternative Minimum Tax (AMT) starting in tax years after 12/31/15 (i.e. the 2016 tax year) for eligible small businesses.
- Unfortunately, the old AMT limitation rules apply for the 2015 tax year.
- Under the existing IRS definitions, an eligible small business is a business that has average gross receipts of under \$50 million for the prior three years.
- Please note that there are still some open issues related to AMT limitation for carryforwards of credits generated in 2015 and prior years and carrybacks of 2016 and later credits to earlier years. We anticipate IRS guidance to be forthcoming shortly.

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Credit may reduce AMT for eligible small businesses starting in 2016.

Certain start-up businesses may take a Payroll Tax Offset.

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Research and Development Tax Credits

Certain Start-up Businesses and Payroll Tax Offset

- Since many start-up firms do not have any income tax liability, the PATH Act now allows certain start-ups to use the credit to offset their FICA payroll taxes.
- This provision is designed to help companies that, typically, have been active for less than six years with gross receipts under \$5 million to be allowed to take the R&D credit even if they don't have any income tax liability yet.
- The PATH Act also allows the credit to be applied against FICA portion of the employer payroll tax. The amount of credit that can be used to offset payroll tax is capped at \$250,000 for each eligible year for no more than a 5 year period.
- To be eligible, a "Qualified Small Businesses" must have less than \$5 million in annual gross receipts and have gross receipts for no more than five years.
- By eliminating AMT for smaller companies and allowing the credit to be taken against payroll tax by small startups, small businesses and S-Corporation shareholders can now take greater advantage of this credit.

Research and Development Tax Credits

Each year, businesses receive hundreds of thousands of dollars in tax credits as a reward for performing one of their integral functions: research and development. Created in 1981, the Research and Experimentation (R&E) Tax Credit, also known as the Research and Development (R&D) Tax Credit, was designed to foster technological innovation within the U.S. and incentivize the hiring of employees to engage in R&D activities. Today, the credit is a boon for businesses, representing an estimated \$5.6 billion in 2009 (Source: <http://www.journalofaccountancy.com/issues/2010/mar/20092122>). While the credit is one of the most lucrative incentives in the tax code, it is also one of the most underutilized, with many businesses erroneously assuming that their activities do not constitute qualified research.

Businesses that reap the rewards of the credit range from very small to very large and represent a wide array of specializations, including engineering, architecture, technology, and manufacturing. The taxpayer is not required to develop a new product or make a groundbreaking discovery. Qualified research may encompass activities such as developing prototypes or models, environmental testing, building or improving manufacturing facilities, and streamlining internal processes

(Source: <http://www.journalofaccountancy.com/issues/2010/mar/20092122>).

A four-part test guides businesses in determining whether their activities may qualify for the credit:

1. The purpose of the activity must be to create new or improve existing functionality of a business component. Architecture firms may find that designs developed for clients satisfy this requirement, as long as they are not purely aesthetic. (Source: AIArchitectThis Week –Architecture Firms Can Get R&D Tax Credits). For tech companies, this may include developing or improving software, as long as the software will not be used exclusively within the taxpayer's company. For manufacturing companies, this may include improving a manufacturing process or facility. Other permissible purposes include pursuit of state, federal, or industry certification.

(Source: "The Research and Development Tax Credit," http://www.ipc.org/3.0_Industry/3.3_Gov_Relations/2008/tax_credit_whitepaper08.pdf), and researching and filing for a patent (Source: <http://www.businessweek.com/small-business/the-rampd-tax-credit-explained-for-small-business-08162011.html>).

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2. The taxpayer must intend to eliminate uncertainty about the project. At the outset of any project, a business likely has questions about how the goal will be achieved and sometimes whether it is worth pursuing at all. If the business proceeds to conduct testing and experimentation in order to answer these questions, it is intending to eliminate uncertainty. For example, an architect taking steps to determine what the optimal final design of a project will be intends to eliminate uncertainty (Source: AIArchitectThis Week – Architecture Firms Can Get R&D Tax Credits).

3. The taxpayer must engage in some sort of systematic process of experimentation designed to evaluate one or more alternatives. Examples include testing, modeling, computational analysis, or even an informal trial and error process.

4. The process of experimentation must be technological in nature and must fundamentally rely upon principles of the physical or biological sciences, engineering or computer science.

Qualified research has been deemed to specifically exclude certain activities, such as:

- Research conducted after the beginning of commercial production. This includes preproduction planning for a finished business component, trial production runs, and accumulating data related to production processes.
- Adapting an existing business component to a customer's specific needs
- Reproducing an existing business component
- Efficiency or consumer surveys, market research, testing, or development, routine data collections, or ordinary testing for quality control
- Any research conducted outside the U.S.
- Any research in the social sciences, including economics, behavioral sciences, or humanities
- Research funded by another person or entity, such as through a grant

(Source: [http://www.irs.gov/Businesses/Audit-Techniques-Guide---Credit-for-Increasing-Research-Activities-\(i.e.-Research-Tax-Credit\)-IRC-%C2%A7-41*---Qualified-Research-Activities](http://www.irs.gov/Businesses/Audit-Techniques-Guide---Credit-for-Increasing-Research-Activities-(i.e.-Research-Tax-Credit)-IRC-%C2%A7-41*---Qualified-Research-Activities))

Once a business determines that it has performed qualified research, it must determine how much it expended on the research. The R&D Tax Credit is calculated based on the amount of qualified research expenses, or QREs, as defined by §174 of the Internal Revenue Code. QREs include the wages paid to employees and amounts paid for supplies used in the conduct of qualified activities. If at least 80 percent of an employee's activities constitute qualified R&D, 100 percent of their wages can qualify for the credit. Section 174 also encompasses certain time-sharing costs for the use of computers in the conduct of qualified research, as well as 65 percent of amounts paid to others within the U.S. for contract research.

Despite these guidelines, businesses seeking to claim the R&D Tax Credit will likely face some complexity and confusion. As a result, claims must be carefully examined on a case-by-case basis to determine whether the taxpayer qualifies. Thorough documentation of R&D activities is essential to support a claim. For example, businesses should keep plans, diagrams, and timesheets of any employees working on the activity.

(Source: <http://www.businessweek.com/small-business/the-rampd-tax-credit-explained-for-small-business-08162011.html>).

If a business does qualify for the credit, the amount of the credit may be calculated using one of two methods:

- Under the traditional method, also known as the regular research credit or RRC, the credit is determined based on increases in research activities and expenditures. The credit equals twenty percent of QREs in a given tax year over an established base amount. Therefore, this method may be best for taxpayers with low base amounts.
- Under the Alternative Simplified Credit method (ASC), the credit equals fourteen percent of QREs over 50 percent of the average annual QREs in the three immediately preceding tax years. If the taxpayer did not incur any QREs in the three preceding years, the ASC method allows for a credit of six percent of that tax year's QREs. The ASC method is often recommended for companies that have a high base amount or incomplete records from the base amount period, or those that have been complicated by mergers and acquisitions (Source: <http://www.journalofaccountancy.com/issues/2010/mar/20092122>).

The law also provides for a 20-year carry forward provision, which is particularly helpful for start-ups that may not have had a tax liability due to lack of income in the years when they were performing most of their R&D. The carry forward provision allows them to claim the credit in future years when they do have taxable income. (Source: <http://www.businessweek.com/small-business/the-rampd-tax-credit-explained-for-small-business-08162011.html>).

In addition to seeking qualification for the federal R&D Tax Credit, businesses should examine whether their states offer an incentive for R&D activities. Minnesota became the first state to offer a R&D credit in 1982. In subsequent years, an additional 42 states have adopted some form of R&D tax incentive. Most state incentives are modeled on the federal credit and use the federal definition of qualified research expense, but states typically allow only QREs incurred within the state to be used in calculating the credit. Percentages used to calculate the credit vary drastically, ranging from 1.25 percent in North Carolina to 40 percent in Louisiana, with the most common rate being around ten percent. With such variation, businesses may find that their state credits are more generous than their federal credits. (Source: "Overview of Research and Development Tax Incentives," http://www.lbb.state.tx.us/Other_Pubs/Overview%20of%20Research%20and%20Development%20Tax%20Incentives.pdf).

Wondering if your research activities qualify for lucrative state and federal tax incentives?

Find out today with a pro bono analysis

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