USING TAX CREDITS TO ENCOURAGE INNOVATION

Both Virginia and federal research tax credits were recently strengthened to provide companies further incentive to expand research and development.

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Major changes to both the Virginia and federal research tax credits take effect this filing season. New legislation will provide Virginia-based companies with one of the most lucrative research and development (R&D) tax savings opportunities in the nation, and the now-permanent federal credit has new provisions benefiting start-up companies and taxpayers paying Alternative Minimum Tax (AMT).

The federal R&D tax credit offers a dollar-for-dollar offset to a company's income tax liability. It's a broad incentive intended to cover millions of taxpayers, and businesses of any size and industry sector can qualify if they meet the criteria governed under U.S. Internal Revenue Code (IRC) Section 41. Many states also offer their own version of the credit, and typically the rules to claim it follow that of the federal credit, with the exception that the costs can only be claimed for activity taking place within the given state. In many instances, businesses qualifying for the credit will be able to claim both the federal and state incentives.

Historically, Virginia has offered its taxpayers one of the best state credits available, often considered to be more lucrative than the federal credit due to its refundability. Yet in 2016, Virginia Gov. Terry McAuliffe surprised taxpayers when he signed new legislation that further broadened the credit's applicability and appeal and extended it until 2022. Businesses in any industry, but specifically those investing significant dollars in R&D, will benefit from these changes.

And thanks to monumental changes stemming from the Protecting Americans From Tax Hikes (PATH) Act of 2015, 2016 was also the first year that business located in any state could begin to utilize the now-permanent federal research credit and its new AMT and payroll tax offset provisions — both of which were enacted to benefit small businesses. Virginia's emerging wine and brewery industries, as well as its expanding technology sector comprised of many startups, will likely look to take advantage of these provisions.

Also in 2016, the U.S. Internal Revenue Service (IRS) issued final regulations related to software development. The favorable guidance contained within these regulations is likely to be embraced by Virginia's government contractor industry, as well as the local and regional financial institution industry that have long been investing in customer-facing software development initiatives, but had been limited to claiming the credit due to stringent requirements.

These new enhancements to the federal and state credit provide Virginia businesses with significant new tax savings opportunities while serving as important tools in enhancing Virginia's competitiveness, as taxpayers will have more reason to consider it a preferred location for R&D investment and activity.

VIRGINIA R&D CREDIT CHANGES

Enhancements to the existing R&D credit

"To invent, you need a good imagination and a pile of junk." — Thomas Edison

And as our country's most prolific inventor, Thomas Edison would also have known that inventing requires a great deal of time and financing. The intent behind R&D incentives is to provide financing to the private sector, whose R&D activities will develop into cutting-edge technologies, create new jobs and grow the domestic economy. And in the case of the Virginia credit, legislators want to attract new businesses into the state. ▶

Highlights

- This filing season, Virginia businesses will be able to take advantage of greatly enhanced research and development (R&D) tax credits in the Commonweatlh.
- A new Virginia R&D credit, the Major Research & Development Expenses Tax Credit, is now available for qualifying taxpayers.
- The federal R&D tax credit is now permanent, with two significant provisions: Alternative Minimum Tax offset and payroll tax offset.

Gov. McAuliffe signed SB 58 into law on March 7, 2016, extending the existing R&D credit to Jan. 1, 2022, and greatly enhancing it as follows:

- The amount each taxpayer can generally claim annually increases from $35,100 up to $45,000. The annual credit limit is now calculated as 15 percent of the first $300,000 in Virginia-qualified R&D expenses to the extent the expenses exceed a base amount.

- If the research was conducted in conjunction with a Virginia public or private college or university, the annual limit per taxpayer increases from $46,800 to $60,000, calculated as 20 percent of the first $300,000 of Virginia-qualified research and development expenses to the extent the expenses exceed a base amount.

- The total amount of credit allowed to all taxpayers annually increases from $6 million to $7 million.

- In addition to the primary credit calculation, a taxpayer may elect a new simplified method of calculating the credit. Under this new alternative simplified computation method, the credit is equal to 10 percent of the excess of the Virginia-qualified R&D expenses paid or incurred during the tax year over 50 percent of the average amount paid or incurred over the three immediately preceding tax years. If you have not incurred Virginia-qualified R&D expenses during any of the three immediately preceding tax years, the credit is 5 percent of the amounts paid or incurred during the taxable year.

- Prior to Jan. 1, 2016, taxpayers making a Virginia state R&D credit claim had to file an application with the Virginia Department of Taxation by April 1. SB 58 changes the application date to July 1.

With the addition of the simplified calculation methodology, which incorporates a 50 percent reduction to the average research spend of a business, even taxpayers that are not increasing their R&D expenses may qualify for this incentive. Also note that if the $7 million cap is not reached by filed claims, taxpayers may actually receive a credit in excess of what they applied for.

The new major R&D credit

"Our greatest weakness lies in giving up. The most certain way to succeed is always to try just one more time."
— Thomas Edison

SB 58 also includes a new form of R&D credit. The Major Research & Development Expenses Tax Credit is available starting in 2016 for taxpayers incurring Virginia-qualified R&D expenditures more than $5 million. The total amount of this credit available to all taxpayers annually is $20 million.

The new credit is calculated in much the same fashion as the federal Alternative Simplified Credit (ASC), and is identical to the simplified calculation method now allowed as an election for the existing Virginia R&D credit. The credit equals:

- 10 percent of the excess of:
    - The R&D expenses paid or incurred activity taking place in Virginia during the taxable year, over
    - 50 percent of average Virginia-qualified R&D expenses paid or incurred by taxpayers for three taxable years immediately preceding the taxable year for which the credit is being determined.

- Or, if no R&D expenses were incurred in any one of three immediately preceding taxable years, then the credit is equal to five percent Virginia-qualified R&D expenses paid or incurred by the taxpayer during taxable year.

The amount of the credit claimed for the taxable year shall not exceed 75 percent of the total amount of the taxpayer's tax liability for the taxable year. And since this credit is nonrefundable, that statute allows for a 10-year carryover.

As with the existing R&D credit, taxpayers who want to claim this credit must file an application by July 1 of the calendar year following the close of the taxable year in which the expenses were paid or incurred. It's also important to note that taxpayers are prohibited from claiming both this credit and the existing refundable credit for the same taxable year, and that no credit is available for R&D expenses incurred in research using embryonic stem cells.

With no limit to how much can be claimed by an individual taxpayer, and a sizeable overall cap of $20 million, businesses investing significant resources in R&D now have serious reason to consider Virginia their home for this type of activity. For example, a business that has invested $5 million each year in R&D in Virginia from 2013 through 2016 may now apply for $250,000 of major R&D credits as opposed to the maximum of $45,000 under the existing general credit.

FEDERAL R&D CREDIT CHANGES

PATH Act provisions to offset AMT and payroll tax

Signed into law on Dec. 18, 2015, the PATH Act made the federal R&D credit permanent and added two significant provisions. For tax years starting after Dec. 31, 2015, taxpayers may be eligible to offset AMT and payroll taxes using the research credit.

AMT offset

"Genius is one percent inspiration and 99 percent perspiration." — Thomas Edison

TABLE 1

TAX PERIOD	2012	2013	2014	2015	2016
GROSS RECEIPTS	50,000	150,000	500,000	750,000	1,000,000
WAGES	100,000	200,000	400,000	500,000	600,000
WAGES QRE	50,000	100,000	200,000	250,000	300,000
R&D CREDIT					18,958

Historically, AMT has served as a limitation barring many small and medium-size businesses from benefiting from the research credit, since prior law prohibited the use of the credit to decrease tax liability below AMT levels. For instance, even if a business was conducting credit-eligible activity and calculating a credit on its tax return, the company would not be able to utilize the credit against its full tax liability if it was subject to AMT. Hence, many businesses found it difficult to justify the work involved in calculating the credit when only a portion, if any, of that credit would be available for their immediate use.

Going forward, the research credit may now offset both regular tax liability and AMT liabilities for taxable years beginning on or after Jan. 1, 2016. Key components of the provision are:

- Applicable to taxable years beginning after Dec. 31, 2015.
- The business (and if a flow-through entity, its partners or shareholders) must have less than $50 million in average gross receipts for the three preceding years.
- Only credits earned after Dec. 31, 2015, apply to the provision (i.e., carryover credits from earlier tax periods will not be allowed to offset AMT).

Thus for those taxpayers who meet the gross receipts test noted above, AMT liability may now be reduced utilizing research credits. This will be an important reason for businesses to consider or reconsider the research credit opportunity in the future. With the opportunity to secure current cash-flow benefit of the credit, (i.e. as opposed to counting on future benefit during the credit's 20-year carryover period), taxpayers suffering from the effects of AMT finally have something to cheer about.

Payroll tax offset

"I have not failed. I've just found 10,000 ways that won't work." — Thomas Edison

Fortunately, a successful invention is not a requirement to claim the federal R&D credit. However, until now, it was necessary to have a tax liability to utilize it. Simply, the federal credit has never been refundable. And although still not refundable, starting in 2016 the research credit may now be utilized to reduce a portion of a qualifying small businesses payroll taxes, thus affording those without an income tax liability a means to benefit currently from the credit. Without this provision, the only other option was to wait for the business to incur an income tax liability during the 20-year carryover period of the credit. Key components of the provision are:

- Applicable to taxable years beginning after Dec. 31, 2015.
- A qualified small business is defined, with respect to any taxable year, as a corporation (including an S corporation) or partnership (1) with gross receipts of less than $5 million for the taxable year, and (2) that did not have gross receipts for any taxable year before the five taxable year period ending with the taxable year.
- Offset limit is up to $250,000 in credit against employer OASDI liability (the employer portion of tax equal to 6.2 percent of all wages).
- The payroll tax credit portion is the least of (1) an amount specified by the taxpayer that does not exceed $250,000, (2) the research credit determined for the taxable year, or (3) in the case of a qualified small business other than a partnership or S corporation, the amount of the business credit carryforward under section 39 from the taxable year (determined before the application of this provision to the taxable year).
- A taxpayer may make an annual election under this section, specifying the amount of its research credit not to exceed $250,000 that may be used as a payroll tax credit, on or before the due date (including extensions) of its originally filed return. A taxpayer may not make an election for a taxable year if it has made such an election for five or more preceding taxable years.
- The payroll tax portion of the research credit is allowed as a credit against the qualified small business's OASDI tax liability for the first ▶

TABLE 2: PAYROLL TAX ON ALL WAGES

2017 TAX YEAR	Q1	Q2	Q3	Q4	TOTAL
WAGES	150,000	150,000	150,000	150,000	600,000
EMPLOYER PORTION OF OASDI (6.2%)	9,300	9,300	9,300	9,300	37,200
ELIGIBLE OFFSET TO ELECT		9,300	9,300	358	18,958

calendar quarter beginning after the date on which the qualified small business files its income tax or information return for the taxable year. The credit may not exceed the OASDI tax liability for a calendar quarter on the wages paid with respect to all employees of the qualified small business.

- If the payroll tax portion of the credit exceeds the qualified small business's OASDI tax liability for a calendar quarter, the excess is allowed as a credit against the OASDI liability for the following calendar quarter.

Providing startups with the opportunity to offset payroll taxes with the research credit will allow these businesses to conserve cash in the years that are most critical to their success. That's good news for them and for our economy, since every dollar that remains in the hands of these growing startups helps drive further innovation and job creation.

Here's an example of application of the provision: A software company started in 2012 has conducted qualifying R&D activity in all the years of its existence. Related Qualifying Research Expenses (QRE) are made up of wages paid to its employees. A summary of pertinent financial data is in Table 1 (see page 27).

Assuming $600,000 in total wages paid, annual OASDI tax liability owed by the software company would be $37,200. With $300,000 in QREs, the software company would be eligible for an R&D tax credit in the amount of $18,958.

Assuming the company files its 2016 federal income tax return on March 15, 2017, (the first quarter of 2017), the eligible payroll offset election would be as follows in Table 2 (above).

Please note that the eligible payroll tax amount to offset is calculated using ALL employee wages, not just the QRE wage amount.

In 2017, this taxpayer would not be allowed to elect to offset payroll tax with IRC Section 41 research credits, since it has gross receipts in five prior tax years. This is a specific exclusion in the new provision, intended to limit the benefit to start-up companies only.

CONCLUSION

"Be courageous! Whatever setbacks America has encountered, it has always emerged as a stronger and more prosperous nation. … Be brave as your fathers before you. Have faith and go forward!" — Thomas Edison

The culmination of the many favorable changes to the research credit at both the federal and state level has created great opportunity for Virginia businesses this filing season and beyond.

The many businesses who have long taken advantage of the Virginia credit will see greater opportunities available this year. For large businesses currently investing significant dollars into R&D, changes to the credit allow more of their investment costs to be offset. While smaller Virginia businesses will also have expanded opportunities to enhance their credit claims due to the increased credit claim amount available this year. Further, smaller businesses limited by AMT, can now utilize the federal credit to alleviate this burden.

And for the very first time, many Virginia businesses will find themselves able to take advantage of the credit due to changes at the federal level. Many of Virginia's growing startups that were heavily investing in R&D but absent of income, hence paying no tax, will finally be able benefit from the credit by offsetting payroll taxes.

One thing is certain, regardless of industry size or sector, Virginia businesses conducting R&D have never had a better time than now to look toward the research credit for tax savings opportunities.

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