Recent changes to the R&D tax credit provide improved incentives for businesses

By Michael Krajcer, JD, CPA

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

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

Prior to 2016, for a taxpayer to benefit from the R&D credit, they had to have a tax liability. Today, 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% 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 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.

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
Wage QRE	$50,000	$100,000	$200,000	$250,000	$300,000
R&D credit					$18,958

Table 1

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

Table 2

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.

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.

Final IRS Regulations for IUS

While the R&D tax credit is intended to be a broadly applicable incentive, Congress had historically taken the position that software developed for internal use (called "internal use software" or IUS) should be subject to a higher standard of credit eligibility. Hence, under IRC section 41 and applicable U.S. Treasury regulations, businesses developing IUS have been required to meet three additional stringent tests to qualify for the credit.

Many taxpayers investing in IUS could not meet these three tests as interpreted by the IRS, and hence have not been able to claim this credit for their software development efforts. Taxpayers have long approached the Treasury with concerns that the applicability of these three additional requirements is too broad in scope and the IRS's interpretation of each requirement has been overly aggressive.

Finally, after nearly 20 years of intense controversy and substantial debate, on Oct. 4, 2016, the Treasury published final regulations related to IUS development under Internal Revenue Code Section 41 regarding to the research credit. Key components of the provision are:

- Definition of IUS: The regulations provide a list of general and administrative functions, intended to target the back-office functions that most taxpayers would have regardless of the taxpayer's industry, and that the characterization of a function as back office will vary depending on the facts and circumstances of the taxpayer.
- Definition of Non-IUS: Added to the existing definition, software that is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system.
- Treatment of dual-function software: Provided rules on how to treat software that has both IUS and non-IUS characteristics, including a safe harbor rule.
- Taxpayers may utilize the new regulations solely on a prospective basis, starting with the tax year beginning on or after Oct. 4, 2016. Or second, for any taxable year that both ends on or after Jan. 20, 2015, and begins before Oct. 4, 2016, the IRS will not challenge return positions consistent with all the provisions of the final regulations.

The final IRS regulations for IUS and Non-IUS are further defined below:

What is IUS?

In 2015, proposed IUS regulations defined software developed for internal use to be computer software developed by (or for the benefit of) the taxpayer, primarily for the taxpayer's use in general and for administrative functions that facilitate or support the conduct of the taxpayer's trade or business. General and administrative functions, as defined in the proposed regulations, are limited to (1) financial management functions, (2) human resource management functions and (3) support services functions. Final regulations did not alter this list of functions or the more detailed list of services that the proposed regulations listed as examples of each.

However, the final regulations again noted that the list of general and administrative functions is intended to target the back-office functions that most taxpayers would have regardless of the taxpayer's industry, and that the characterization of a function as back office will vary depending on the facts and circumstances of the taxpayer. In addition, the final regulations clarified that the determination of whether software is developed primarily for internal use depends on the intent of the taxpayer and the facts and circumstances at the beginning of software development.

What isn't IUS?

Although not substantively changing the definition, final regulations clarified that software is not developed primarily for the taxpayer's internal use if it is not developed for use in general and for administrative functions that facilitate or support the conduct of the taxpayer's trade or business; and examples of software that are not regarded as IUS includes (1) software that is developed to be commercially sold, leased, licensed or otherwise marketed to third parties and (2) software that is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system.

What if it's both?

The final regulations maintain the presumption of internal use, when both IUS and non-IUS software are being developed as part of an integrated system. Referred to as "dual function" software in the regulations, taxpayers will have the burden of proof to overcome the presumption of internal use for the non-IUS portion of the integrated functions of the software. However, to the extent that the taxpayer can identify a subset of the dual function computer software which is only non-IUS, then for that subset of the software development the presumption of internal use does not apply. After identifying non-IUS subsets of the software system, there may still exist dual function software. The IRS had provided a safe harbor approach to dealing with this dual function software. In the final

regulations, the proposed regulations safe harbor rules were retained and favorably revised to be more industry specific.

The safe harbor rules for dual function software allow the taxpayer to include 25% of the qualified research expenditures of the remaining dual function subset in computing the amount of the taxpayer's credit. However, the taxpayer must be able to substantiate that the use of the dual function subset by third parties or by the taxpayer to interact with third parties is reasonably anticipated to constitute at least 10% of the dual function subset's use and that the taxpayer's research activities related to the dual function subset constitute qualified research. The final regulations contain a taxpayer favorable change in this section, providing that any objective, reasonable method within the taxpayer's industry may be used for purposes of the safe harbor.

Michael Krajcer is the President of Tax Credits Group, a Cleveland-based R&D tax credit consulting firm. He has more than 25 years of experience in research tax credit consulting and related IRS/state tax controversy resolution. He may be contacted at **michael@taxcreditsgroup.com**.

FAST FACTS

1. The federal R&D tax credit is now permanent, and a permanent annual credit provides taxpayers with an opportunity to properly plan and budget for future R&D initiatives.
2. Legislation changes also brought forth two new opportunities for certain eligible small businesses to offset payroll and Alternative Minimum Taxes (AMT), in addition to or in lieu of income tax.
3. Many small businesses who found themselves in AMT were unable to benefit from the research credit. Today, these same small businesses now have opportunity to alleviate this tax burden.
4. The new payroll tax offset provision allows cash-strapped startups to immediately benefit from tax savings in the years where they need it most.
5. New Treasury Regulations broaden the definition of internal use software (IUS), making it easier for businesses investing in this area to claim this incentive.
6. Final regulations continue a recent line of "pro-taxpayer" legislation, regulation and court rulings relating to the research credit, which will allow for the expanded utilization of this incentive and reduce the controversy that has historically plagued taxpayers who have claimed it.