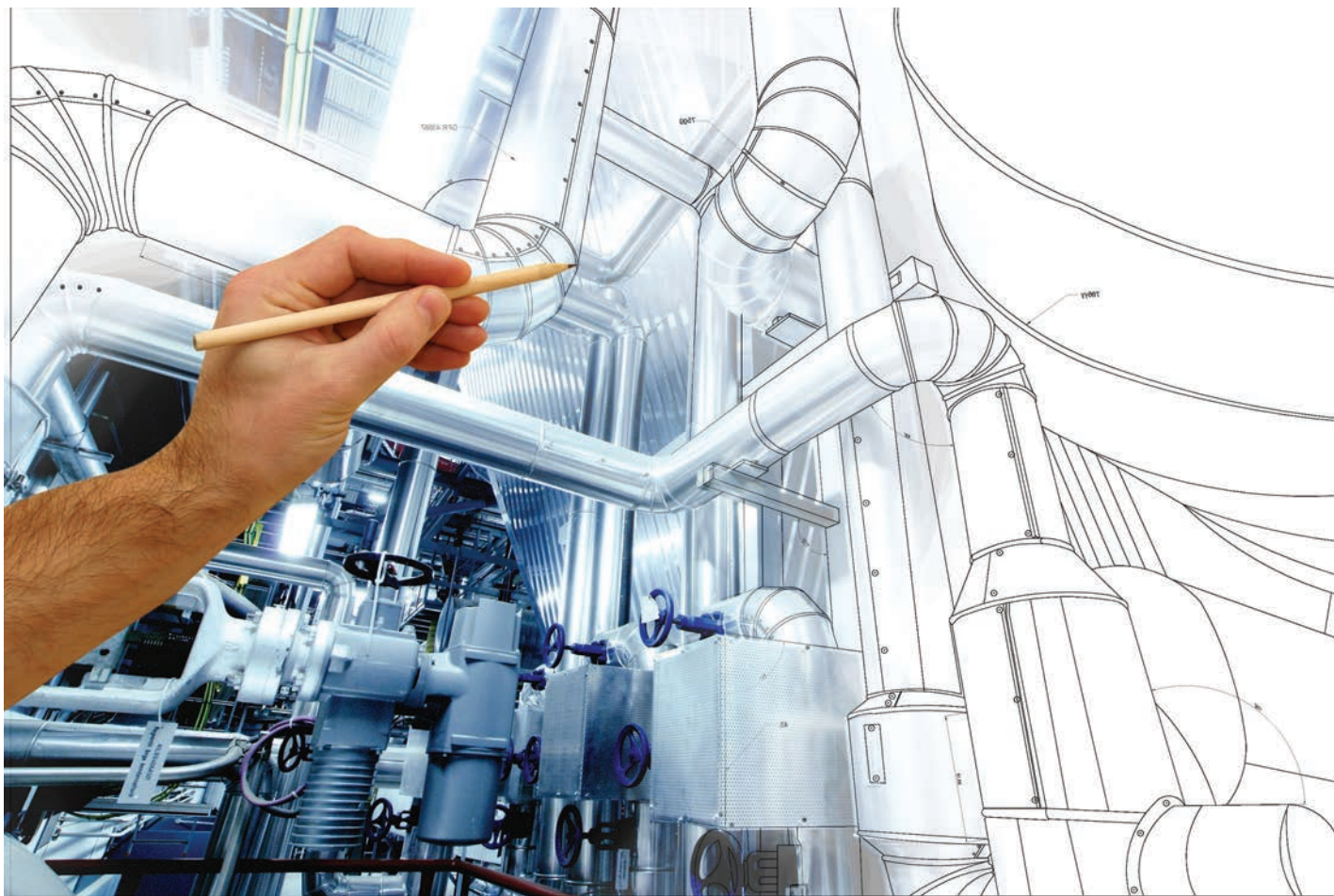


ENCOURAGING INNOVATION

New federal and Virginia opportunities
with R&D tax credits



BY MICHAEL KRAJCKER, CPA

More than three decades after Congress passed the original legislation creating the Research and Development (R&D) Tax Credit, intended to stimulate the stagnant economy of the early 1980s, it is finally a permanent part of the U.S. Tax Code. The credit was included in the PATH Act of 2015, signed into law by President Barack Obama on Dec. 18, 2015. ▶

A permanent R&D tax credit is great news for innovative businesses, most of which have long understood its bottom-line value, but have been reluctant to make it a larger part of their tax strategy due to the perception of instability. And along with this new permanency, legislatures have also introduced a few surprises to freshen the 35-year-old credit.

The Alternative Minimum Tax (AMT) turnoff

One of the major changes to the new and improved R&D credit is that it now allows small business owners to claim it against their AMT liability. In the past, the AMT served as a *defacto* barrier to many small businesses attempting to recoup their innovation expenses. Removing this barrier provides a new incentive for these businesses to reprioritize or even double-down on their R&D spending. This provision applies generally to taxpayers with less than \$50 million in gross receipts, and is effective for tax years starting after Jan. 1, 2016.

The payroll tax offset

Early-stage startups have something to be excited about, since they can now claim R&D expenses against their payroll taxes for up to five years. Technically, these startups have always been eligible to claim the R&D credit, but there was very little incentive for them to do so, since the credit was only useful for offsetting income tax and most startups are not yet profitable. This provision applies generally to taxpayers with less than \$5 million in gross receipts, and is effective for tax years starting after Jan. 1, 2016.

For those who have followed this 30-year saga, both of these changes cut to the core of what the R&D credit was always supposed to be about. By making the credit permanent, eliminating the AMT barrier and bringing into the fold our nation's stable of cutting-edge tech startups, legislators will almost certainly incentivize more innovation than ever before.

A BRIEF HISTORY OF THE FEDERAL R&D CREDIT: 1981–2015

The Research and Development Tax Credit was originally enacted in 1981 as part of the Economic Recovery Tax Act. It came during a time of widespread concern that the U.S. economy — then strapped to the back of the flagging domestic automobile industry — was simply unable to compete in the face of globalization.

Legislators were only able to agree on a temporary credit, set to expire at the end of 1985, but it was eventually extended. Thus began an awkward cycle in which the credit, ostensibly popular across party lines, became a kind of political football, being allowed to expire eight times before eventually being renewed retroactively after negation. In total, the credit was temporarily extended 15 times before Congress finally made it permanent.

Amidst these years of party politics, a significant change came in 2003, when regulators formally eliminated the “Discovery Test,” a *defacto* rule that essentially required U.S. companies to make revolutionary new discoveries in their industry in order to qualify for the R&D tax credit. Like the AMT barrier, this test threw up a large obstacle for many companies who were working hard to stay competitive, but were unable to claim some “revolutionary” invention in their particular industry.

By clarifying that companies were only required to make discoveries that were “new to them,” the new regulations opened the door for many of these companies. However, it also drew the attention of U.S. Internal Revenue Service (IRS) auditors, who began to exercise more scrutiny over some new R&D claims.

The second major change to the credit came with the introduction of the Alternative Simplified Credit (ASC) calculation, an alternative method to the general calculation methodology. Although the ASC can result in less total credits calculated, the calculation is simpler, requires less historical information

than the general method and has traditionally been the preferred methodology of the IRS. In addition, the need to increase R&D expense to earn credits is significantly reduced by this method, via a statutorily allowed reduction to the base amount component of the calculation. These factors have combined to make it a popular option in recent years, especially for proactive companies looking to plan out a long-term R&D strategy.

WHAT IN THE WORLD IS A QRE?

Whether they choose the simplified or general method of calculation, the R&D credit is ultimately calculated by defining how much of a company's activities during the year(s) are directed toward research and development. Determining whether or not specific company activities meet the government definition of R&D means exposing them to a “four-part test” designed to determine whether they:

1. Meet the permitted purpose of the regulations (for example, developing a new or improved product or business process);
2. Involve some level of technical uncertainty;
3. Follow a process of experimentation;
4. Involve the use of one or more scientific principles, such as chemistry, engineering or computer science.

Once the activities that meet these tests are identified, a taxpayer must calculate the credit eligible expenses. Unfortunately, not all R&D expenses qualify for the credit. Only Qualified Research Expenditures (QRE) may be included in the credit calculation, categorically defined as:

- >> Wages
- >> Supplies
- >> Contract Research (i.e. vendor-conducted R&D)

Depreciable assets utilized in the conduct of R&D (e.g. research facilities, test labs, computers, etc.) are statutorily excluded.

R&D IN THE REAL WORLD

Beyond the regulatory barriers, many companies do not claim the R&D credit because they follow a much more strict definition of R&D than the government. The easiest way to explain this difference is to use a specific industry example. Take injection molding. A molding company attempting to create a totally new product using a type of polymer that has never been successfully integrated into the manufacturing process would obviously qualify for the R&D credit.

But what about a molder that is attempting to make a legacy product stronger or lighter. What if they simply want to make the product more cost-effective to manufacture? Often, they do not realize that these activities also qualify as R&D.

The same logic holds true for companies attempting to automate their manufacturing processes or redesign their molds and manufacturing methodologies to save time, money or both. Even if they are not the first company in their industry to do what they are attempting to do, their work meets the government definition of R&D, since it is still new to the company undertaking the effort, and often carries with it a great deal of technical uncertainty as a result.

In the real world, R&D often takes place far outside the laboratory. That's why the day-to-day activities of many U.S. companies attempting to leverage technology and innovation to get ahead or stay ahead are likely to qualify for the R&D credit. It's only fitting, considering the mission of those who passed the original credit in 1981.

THE VIRGINIA R&D TAX CREDIT

In addition to the federal R&D credit, many states also offer some form of incentive for companies attempting to leverage innovation.

However, there is a great deal of variation between these state credits and some accomplish their goals much more effectively than others.

Historically, the Virginia R&D Credit has been one of the most effective state credits available, and has recently been improved. Beginning in 2014, the credit limit has been increased to now allow a maximum credit of 15 percent (20 percent if research was conducted in conjunction with a Virginia public or private college or university) of the first \$234,000 of qualified Virginia research expenses (equal to a \$35,100 credit). In addition, the annual cap for the credit has been increased from \$5 million to \$6 million.

And it's REFUNDABLE! A taxpayer that does not utilize all its credit against current tax liability may receive a refund of the excess. In some cases, a taxpayer may want to claim the Virginia credit since it is refundable and forgo claiming the federal credit if it cannot be utilized (the federal credit is not refundable, but can be carried back one year and carried forward 20 years). There is no requirement that to claim a state credit, a taxpayer must also claim a related federal credit.

Although the Virginia credit statute generally defers to the federal credit statute for the definition of qualifying activity and eligible expenses, there are some very important differences to be aware of. For example:

- >> The research and development activity must take place in Virginia.
- >> Claimed expenses for the credit must be incurred for Virginia qualified research.
- >> A taxpayer must submit its application for the credit to the Virginia Department of Taxation by April 1, 2015. No extensions are allowed.

For tax planning purposes, please note that the credit has been extended through Dec.

31, 2018. In addition, the credit may be used by the owners of a flow-through entity, or elected to be utilized at the entity level. Finally, expenses used in the calculation of the Virginia R&D Credit may not be utilized as a basis for claiming any other credit allowed under the Code of Virginia.

CONCLUSION

Today's revitalized R&D credit is arguably closer than it has ever been fulfilling the original mission of its authors to incentivize homegrown innovation and keep the U.S. competitive in a rapidly evolving global marketplace.

A permanent federal credit brings with it the stability successful companies need to make the credit a larger part of their overall R&D strategy. Meanwhile, the new perks for startups and growing small businesses help to ensure we are not neglecting the young companies that will come to define our economic future.

If more states begin following the lead of forward thinkers like Virginia, the positive effects of the revitalized federal R&D credit will only be magnified. That's good for business, as well as the long-term health of the U.S. innovation economy. ■



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