



Research and Development Tax Credit

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Historical Overview

- Research Tax Credit first enacted in 1981 as part of the Economic Recovery and Tax Act (ERTA)
- In subsequent years the credit has expired and been extended 17 times and been significantly modified 5 times
- The credit was enacted as an incentive for business to increase investment in certain research activities by reducing the after tax cost of such activities
- Opinions vary as to the credit's overall effectiveness at boosting research expenditures

Criticisms

- The credit was not a permanent part of the revenue code
- It was believed to have a weak or uneven incentive effect
- It was not refundable
- The definition of qualified research remains incomplete or ambiguous (a major source of disputes between the IRS and taxpayers)
- The credit is not targeted at investments that are likely to generate large economic benefits

Trends

Table 3. Business and Federal Spending on Domestic Research and Development, and Claims for the Federal Research Tax Credit, 2000 to 2010
(\$ billions)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Business Spending on Domestic R&D (BSDRD) ^a	\$183	\$185	\$177.5	\$183	\$188	\$204	\$223	\$243	\$254	\$243	\$245
Qualified Research Spending (QRS) ^b	\$110	\$100	\$116	\$124.5	\$116	\$130	\$145	\$158	\$151	\$143	\$160
Federal R&D Spending ^c	\$76	\$84.5	\$94	\$103.5	\$112	\$119	\$122	\$127	\$127	\$133	\$147
Current-Year Research Tax Credit ^d	\$7.2	\$6.4	\$5.7	\$5.5	\$5.6	\$6.4	\$7.3	\$8.3	\$8.3	\$7.9	\$8.5

Credit ratio

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Ratio of Credit to BSDRD (%)	3.9%	3.5%	3.2%	3.0%	3.0%	3.1%	3.3%	3.4%	3.3%	3.2%	3.5%
Ratio of Credit to QRS (%)	6.5%	6.4%	4.9%	4.4%	4.8%	4.9%	5.0%	5.2%	5.5%	5.5%	5.3%

2015 – Protecting Americans from Tax Hikes (PATH) Act

- The Credit was made permanent
- Eligible Small Business (less than \$50M in gross receipts) can use the credit to offset Alternative Minimum Tax (AMT)
- Qualified Small Business (QSB) can use the credit against payroll taxes

AMT offset

- Effective for years beginning after 2015
- Eligible Small Business (ESB) - Average annual gross receipts for three year period preceding tax year cannot exceed \$50,000,000
- If the entity is a flow through (Partnership or S-Corporation) the revenue test must be met at the entity level and at the partner or shareholder level

Payroll Tax Offset

- Qualified Small Business (QSB) – Gross receipts for the taxable year is less than \$5,000,000 and did not have any gross receipts in any taxable year preceding the 5 taxable year period beginning with such taxable year
- Election must be made before the due date of the return (including extensions)
- Election must specify the amount of the credit that such election applies
- \$250,000 maximum amount
- Cannot claim for more than 5 years
- Election can only be revoked with the consent of the Secretary

- Credit can be only taken against the employer's old-age survivors disability and insurance liability (OASDI or "social security" portion of the employer's FICA tax)
- Cannot be taken against the hospital insurance liability (HI portion of FICA taxes)
- Cannot be taken against employee's portion of tax that is required to be withheld by the employer
- Can begin to take the credit in the next quarter beginning after the date the return containing the election is filed

Description of the Research Credit

- The research credit can be claimed for qualified research expenses (QREs) conducted as a part of a taxpayers trade or business
- QREs include in-house research expenses and contract research expenses

In-House Research Expense

- Wages paid to those conducting qualified research or supervising qualified research
- Cost of supplies used to conduct research
- Amounts paid for the use of computers used to conduct qualified research

Contract Research Expenses

- 65 % of amounts paid to those other than employees to conduct qualified research
- Prepaid amounts are only includable when the research is performed
- 75 % of expenses paid to a qualified research consortium – including the taxpayer and at least other unrelated taxpayer
- 65% of amounts paid to eligible small business, universities and Federal laboratories – 100% if paid for energy research

Qualified Research

- 1) The expenditures qualify as expenses under IRC Sec. 174
- 2) The research must be undertaken to discover information that is technological in nature; i.e., it must rely on the principles of the physical, biological, engineering or computer sciences
- 3) Substantially all of the research must contain elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality
- 4) The application of the research is intended to be useful in the development of a new or improved business component of the taxpayer

The Purpose of the Research Should Relate to

- 1) A new or improved function
- 2) Performance
- 3) Reliability or quality
- 4) Cannot be related to style, taste, cosmetic or seasonal design factors

Business Component Purpose Matrix

Business Component Purpose Matrix					
The Project's	The Purposes of the R&D Activities Related To The Development of New or Improved:				
Business Components	Function	Performance	Reliability	Quality	Durability
Product	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Process	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Computer Software	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Technique	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Formula	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Invention	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Qualified Research Does Not Include

- 1) Research after commercial production
- 2) Adaptation of existing business components (adapt to particular customer's needs)
- 3) Duplication of existing business component
- 4) Surveys, studies, etc. (efficiency survey, market research, QC testing or inspection)
- 5) Computer software (Unless internally developed for QRE or production purposes)
- 6) Foreign research
- 7) Social sciences, arts or humanities
- 8) Funded research

Computation of Credit

General Rule – Credit is the sum of:

- 1) 20% of the excess (or increase) in Qualified Research Expenditures (QRE) for the current year over the base amount.
- 2) 20% of the excess (or increase) in basic research payments for the current year over a base period
- 3) 20 % of the amount paid to an energy consortium for energy research

Deduction for R & D expense pursuant to IRC Sec 174 must be reduced by the amount of the credit calculated

Base Amount

- In general – the fixed base percentage times the average annual gross receipts of the taxpayer for the past four years
- Minimum amount – In no event shall the base amount be less than 50% of the current year qualified research expense
- The fixed base % is 3% for the first five years the tax payer has qualified expenses. Next five years are computed under a weighted average formula
- Maximum percentage. – The maximum fixed base % cannot exceed 16%

Alternative Simplified Credit (ASC)

- 14% of the current QRE in excess of 50% 3 year average QRE
- If no QRE in any 1 of 3 preceding years the credit is 6% of QRE
- Election is effective until revoked with the consent of the Secretary
- Deduction of R & D expense pursuant to IRC Sec. 174 does not have to be reduced by the credit calculated
- New IRS Regulation issued in Feb 2015 allows taxpayer who did not claim a credit on an original return may use the ASC method for calculating the credit on an amended return

Funded Research

- Contingent on success
- Substantial rights

Contingent on Success

- Fairchild Industries, Inc. v. United States
- Fixed prices contract was held not to be funded since payment was contingent on success
- At the time the contract was entered it was not known whether or not the research would be successful or accepted by the Air Force

Substantial Rights

- Lockheed Martin Corporation v. United States
- It was held that Lockheed retained substantial rights to research performed even if it did not have exclusive rights
- Recoupment provision did not restrict Lockheed's right to use the results of the research
- Recoupment provision was merely a way for the Government to recover a portion of the cost of the research