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The Research & Development Tax Credit

Without question, one of the major highlights of the recently enacted PATH Act of 2015 is the provision making the R&D Tax Credit permanent. The landmark bill also provides a significant change for many shareholders of Sub S Corps and LLC's. For tax years beginning after December 2015, shareholders who are in Alternative Minimum Tax (AMT) will be able to use the research credits to offset minimum tax. Prior to this it could not be used to reduce AMT. This article addresses frequently asked questions surrounding R&D criteria.

PATH Act Permanency

The R&D credit extension, part of the Protecting Americans from Tax Hikes (PATH) Act of 2015, presents several important enhancements to expand how R&D credit benefits can be currently utilized.

R&D Tax Credit Facelift

Historically, the benefits of applying for R&D tax credits have mostly been limited, with little or no benefits. However, as a result of two key changes made within 2015 tax laws, this is no longer the case and businesses are finally able to benefit from this business credit.

- Eligible small businesses (ESB) and their owners may take the R&D credit against their Alternative Minimum Tax (AMT).

  An ESB is defined as a sole proprietorship, partnership, or non-publicly traded corporation with average annual gross receipts for the prior three tax years that do not exceed $50 million. Partners of a partnership and shareholders of an S corporation must separately meet the gross receipts requirement to use the R&D credit against their individual AMT liability. The new rule removes a frequent obstacle associated with R&D credits, particularly for owners or members of pass-through entities.

- Certain qualified small businesses (QSB) may take the R&D credit against their payroll taxes (essentially making it refundable) for five years.

  A QSB is a corporation (including an S corporation) or partnership that meets both of the following tests: (1) It has gross receipts of less than $5 million for the credit-claiming year, and (2) it did not have gross receipts for any tax year preceding the five-tax-year period ending with that tax year.

  As the R&D tax credit is nonrefundable, this change in the law to offset payroll taxes provides a significant cash flow opportunity for startups that do not have a tax liability to otherwise offset the credit.

NOTE: The payroll tax offset will be available on a quarterly basis beginning in the first calendar quarter that begins after a taxpayer files their federal income tax return. Taxpayers would need to file their 2016 federal income tax returns by March 30, 2017, to apply the payroll tax offset to the second quarter. As a result, the earliest taxpayers are likely to see a benefit is July 2017, when they file their quarterly payroll tax returns for the second quarter (Form 941).

Who Qualifies?

The R&D tax credit can be a rewarding incentive for businesses and applies far more broadly than is assumed by many business owners.

To qualify for the R&D tax credit, businesses must have:

- Developed products or processes using specific know-how that is treated as a trade secret or is patentable.
- Developed a new or improved product that advances the state of the art, and required one or more redesigns, simulations, mock-ups and/or experimental trials.
- Developed or incorporated a new technology in order to catch up to a competitor.
- Attempted to develop a product or process improvement but it was eventually abandoned. (A project does not have to be successful to be eligible).
- Incurred costs for any of the following:

  Development of new equipment, new manufacturing techniques or proprietary processes.

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The R&D Tax Credit

Design and development of prototypes for clients.

Development of special purpose tooling.

Material consumed during testing.

Consultants, subcontractors, and contracted test labs.

There is a simple four-part test to help determine if R&D tax credit eligibility fits into the criteria of the Internal Revenue Code (IRC):

1. **Elimination of Uncertainty (Section 174 Test):** You must demonstrate that you've attempted to eliminate uncertainty about the development or improvement of a product or process. In other words, something that has been changed solely for aesthetic purposes would not qualify.

2. **Process of Experimentation:** You must demonstrate – through modeling, simulation, systematic trial and error or other methods --- that you've evaluated alternatives for achieving the desired result.

3. **Technological in Nature (The Discovering Technological Information Test):** The process of experimentation must rely on the hard sciences, such as engineering, physics, chemistry, biology or computer science.

4. **Qualified Purpose (The Business Component Test):** The purpose of the research must be to create a new or improved product or process, resulting in increased performance, function, reliability or quality.

Businesses that would likely benefit

- Gross sales generally greater than $5 million, or
- Annual payroll generally greater than $1million
- Profitable or has diminishing Net Operating Losses

Eligible industries

- Manufacturing
- Software and Hardware Development
- Biotechnology, Pharmaceutical, Medical Device
- Contract Manufacturing and Labs
- Engineering (mechanical, electrical, civil)
- Food and Beverage Processors
- Companies with E-Commerce sites
- Technology
- Others

Examples of Qualifying Research Activities

- Conduct testing of new concepts and technology
- Develop prototypes and models
- Develop new, improved or more reliable products, processes or formulas
- Develop or apply for patents
- Add equipment that improves a process
- Streamline your manufacturing process
- Develop new software
- Design for LEED/green initiatives
- Conduct environmental testing
- HVAC concept and design

Benefits of the R&D Credit

- Federal and State tax credits can amount to as much as 20% of the costs incurred in developing new products and/or manufacturing processes, or improving existing products and processes.
- You can go back 3 years to claim past credits.
- You can carry forward credits for up to 20 years.

Also, if you take the federal R&D credit, you may qualify for a state R&D credit on eligible expenditures made in Vermont. The Vermont credit can be taken in an amount equal to 27% of the federal tax credit allowed in the taxable year. This credit applies to personal income tax or business or corporate income tax. Any unused credit available may be carried forward up to 10 years.

For more information and to determine if your business might be in a position to take advantage of these tax credits please call our office at 802.878.1963 (Williston) or 802.775.7132 (Rutland) and we will connect you with the necessary resources.

References and Resources:

The Research & Development Tax Credit for Manufacturers, 2016, Business Resources Services, South Burlington, VT; www.brsvt.com.

How to Qualify for R&D Tax Credits: The Four-Part Test, 04/28/2016, Tax Point Advisors, www.taxpointadvisors.com.

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