The Research & Development Tax Credit: Underclaimed And Misunderstood

By Ben A. Kaplan

Many small and medium sized companies do not realize that they can create significant additional business value by connecting their day to day activities with the R&D tax credit. Evolutionary improvements in their products or processes may qualify for the research credit. The purpose of the R&D tax credit is to encourage technological innovation by rewarding experimentation (including failure). The intent of this article is to educate attorneys about the R&D tax credit so they can unlock business value for their clients.

The federal R&D tax credit[1] gives taxpayers conducting qualified research the ability to claim a research credit of 9.1[2] percent or 13 percent of *incremental* R&D spending in order to lower their regular federal income tax bill. Many states have their own version of the research credit. Some states have refundable credits.

At the federal level, $9.2 billion[3] of R&D credits was claimed in 2011 (the last year for which statistics are available). An analysis of National Science Foundation statistics[4] shows that another $3-4 billion in R&D credits could have been claimed. Many taxpayers that engage in eligible activity erroneously disqualify themselves from claiming the R&D tax credit because of various misconceptions, 10 of which are listed later in this article.

In order to qualify for the research credit the claimant must satisfy four criteria[5]:

1. Attempt to develop a new or improved product, process or other business component
2. Employ scientific or technological principles in the above activity
3. Possess an element of technical uncertainty at the outset with regard to either capability, or method or design[6] in the development or improvement effort
4. Engage in a systematic process of experimentation that attempts to resolve the above technical uncertainty

The federal research credit is for *increasing research activity* which presupposes a base amount. There are two options for calculating a base amount: (1) the *regular method* or (2) the *alternative simplified credit (ASC) method*. Under the regular method the base amount can never be less than 50% of the current year's qualified research spending and can never be more than 16% of the prior 4 year average gross receipts.[7] Under the ASC method the base amount is 50% of the prior 3 year average of qualified research spending.

The credit amount under the regular method is 13% of the current year's spending in excess of the regular base amount. The credit amount under ASC is 9.1% of the current year's spending in excess of the ASC base amount.[2]

On June 3, 2014 the IRS issued TR § 1.41-9T which now permits taxpayers to file amended claims using the ASC method. This supersedes the previous regulation which prohibited the filing of amended claims using the ASC method (taxpayers were always permitted to file amended claims using the regular method). However, taxpayers cannot amend previous returns and change from the regular method to the ASC method. Also, a member of a controlled group may not file an amended return using ASC if any member of the controlled group previously claimed the credit using the regular method. The new regulation permits taxpayers to amend prior years as long as the statute of limitations is open.

Many taxpayers that are eligible mistakenly disqualify themselves from claiming the R&D tax credit because of one or more of the following myths:

Myth #1: The R&D tax credit is only for taxpayers that invent something revolutionary.

Fact: TR §1.41-4 (a)(3)(i) states: "Research is undertaken for the purpose of discovering information if it is intended to **eliminate uncertainty** concerning the development or improvement of a business component. **Uncertainty exists if the information available to the taxpayer** does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component."

- Note there is no defined quantum of uncertainty.

Myth #2: The R&D tax credit is only for taxpayers engaged in basic research.

(continued on Page 11)

RESEARCH & DEVELOPMENT...

(continued from Page 2)

Fact: TR §1.41-4 (a)(3)(ii) states: "A determination that research is undertaken for the purpose of discovering information that is technological in nature d**oes not require the taxpayer be seeking to obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science** or engineering in which the taxpayer is performing the research."

- Of course a taxpayer cannot turn their back on publicly available information and claim uncertainty.

Myth #3: The R&D tax credit is not available to taxpayers that fail in their research efforts.
Fact: TR §1.41-4 (a)(3)(ii) states: "In addition, a determination that research is undertaken for the purpose of discovering information that is technological in nature **does not require that the taxpayer succeed** in developing a new or improved business component."

- The research credit is an efforts based credit not a success based credit.

Myth #4: The R&D tax credit won't help my client because my client is not profitable.
Fact: The federal R&D credit is not refundable, it can only be utilized as a credit against regular income taxes. However, 26 USC §39 (a) (1) provides that
business credits **can be carried back one year and carried forward 20 years.**

- In addition, some states provide for refundable credits. Maryland has a refundable credit for small business. See Md. Tax-Gen. Code Ann. § 10-721(a)(7) & (d)(2). Virginia's credit is refundable without restriction. Va. Code. Ann. § 58.1-439.12:08 F. Delaware's credit is not refundable but a small business credit is double the credit rate of a large business (20% vs. 10%). See 30. Del. C. § 2070 (b)(2).

Myth #5: The R&D tax credit is only for big companies.
Fact: There are no company size requirements; eligibility is solely based on activity. In 2011 about 14,672 companies claimed the credit. Fifteen percent of the claimants had revenues under $25,000; 41% had revenues below $5 million.

RECEIPTS	NUMBER OF CLAIMANTS
Under $25,000	2,155
Under $500,000	3,074
Under $1 million	3,434
Under $5 million	6,000
Under $10 million	7,412
Under $250 million	12,596
Total Claimants	14,672

Per IRS Statistics of Income (SOI)[8]

Myth #6: The R&D tax credit is not available to my client because their research is funded by the government or other third party.
Fact: If the taxpayer is (1) at financial risk and (2) retains substantial rights to the research, then the taxpayer is eligible to claim the credit. See TR. §1.41-4A(d)

- The taxpayer is considered at financial risk under a fixed fee contract payment arrangement. See *Geosyntec Consultants, Inc. v. United States*, U.S. Dist. LEXIS 140185 (2013) and *Fairchild Indus., Inc. v. United States*, 71 F.3d 868 (Fed. Cir. 1995).
- Substantial rights need not be exclusive rights. As long as the taxpayer has the right to use the results of the research without payment the taxpayer has substantial rights. *Lockheed Martin Corporation v. United States*, 210 F.3d 1366 (Fed. Cir. 2000).

Myth #7: The R&D tax credit won't help my client with state taxes.
Fact: About two-thirds of states offer an R&D tax credit. Some states provide refundable credits; others provide for carrying the credit forward. Most state eligibility requirements mimic federal eligibility requirements, though some may restrict, include or provide for enhanced credits for specific types of research. The most common differences between federal and state R&D credit computations relate to the credit rate and the base amount computations.

Myth #8: The R&D tax credit is not a big deal since my client is already benefitting from a deduction.
Fact: The credit is **in addition to the deduction**. The credit is a dollar for dollar reduction against regular income tax liability.

Myth #9: The R&D tax credit is for increasing research spending; since my client's spending is flat, my client is not eligible.
Fact: While it is true that the federal R&D credit does require increased spending, the increased spending is **compared to a base amount**. There are 2 alternate methods for computing the base. Under ASC the base is 50% of the prior 3 year average, so that in fact your client's current year spending could actually be decreasing and they would still be entitled to a credit for the increment.

Myth 10: The R&D tax credit expired, so it's too late.
Fact: The federal credit expired on December 31, 2013 but is not too late to claim the credit. One could always amend and claim prior years using the regular method.

(continued on Page 12)

Research & Development...

(continued from Page 11)

- Under a just released (June 3, 2014) regulation TR § 1.41-9T the IRS will now accept amended returns using the ASC method.
- Under Rev. Rul. 82-49 unclaimed credits from closed years are not barred from open years.

The federal credit (in its present form) was first passed in 1986, the credit has always been temporary and has been renewed 15 times, almost always retroactively. There are various bills pending in Congress for renewal. The House passed a bill making it permanent and increasing the credit rate to 13% from 9.1% using ASC and abolishing the regular method. The Senate Finance Committee passed legislation extending the credit for 2 years and permitting small businesses to use the credit against AMT and also to use the credit against payroll taxes. The credit is very likely to be renewed, given the current economic climate.

- State R&D credits remain in effect based on their individual sunset provisions.

Talk with your clients and explore whether any of the above myths have discouraged them from claiming the benefits of the R&D tax credit. Suggest that they examine their business activities to see whether any activity satisfies the four eligibility criteria listed above. The areas typically overlooked are process improvements. It is not too late. Taxpayers may amend prior-year tax returns and retroactively claim the credit. The new regulation (TR § 1.41-9T) which now allows claimants to use the ASC method when amending prior years makes the credit even more accessible. Amended returns may invite IRS scrutiny but a well-documented study will sustain the refund claim. Additionally, many states permit amending prior-year tax returns and retroactively claiming the credit.

Help your clients unlock the hidden business value of their activities by advising them on how to reduce their tax liability by claiming the research credit.

Endnotes

[1] 26 USC § 41 Credit for Increasing Research Activities

[2] Under ASC, if there are less than 3 prior years of research spending the credit rate is reduced to 3.9% (instead of 9.1%) of current year spending with no comparison to a base amount.

[3] Statistics of Income Tax Stats: Table 1. Corporations Claiming A Credit For Increasing Research Activities on Form 6765 Selected Items, by Sector Tax Year 2011

[4] National Science Foundation, National Center for Science and Engineering Statistics; *U.S. R&D Resumes Growth in 2011 and 2012, Ahead of the Pace of the Gross Domestic Product*, Arlington, VA (NSF 14-307, December 2013). http://www.nsf.gov/statistics/infbrief/nsf14307/

[5] Internal Use Software (IUS) requires the taxpayer to meet 3 additional eligibility criteria. IUS is software that is developed primarily for the taxpayer's internal use (typically general and administrative functions such as payroll or bookkeeping) and is not part of a production process and is not part of jointly developed hardware and software and is not intended to be commercially sold or licensed or otherwise marketed for separately stated consideration to third parties.

[6] A patent (non ornamental) is a safe harbor for this requirement.

[7] Under the regular method the base years are either1984-1988, assuming the taxpayer had both gross receipts and qualified research expenditures in three of these five years, or actual post-1988 years when the firm had both gross receipts and qualified research expenditures. The relationship between gross receipts and qualified research expenditures in the base years establishes the fixed-base percentage. The fixed-base percentage multiplied by the average gross receipts for the prior four years equals the base amount. To the extent the current year's qualified research spending exceeds the base amount, the taxpayer is eligible for the research credit. However for federal purposes the fixed base percentage can never exceed 16%. (Maryland does not cap the fixed base percentage).

[8] Statistics of Income Tax Stats: Figure B. Corporations Claiming a Credit for Increasing Research Activities; Number of Credit Claimants by Size of Business Receipts; Tax Years 1990-2011