More R&D tax help

New AMT and payroll tax offsets widen the credit's utility.

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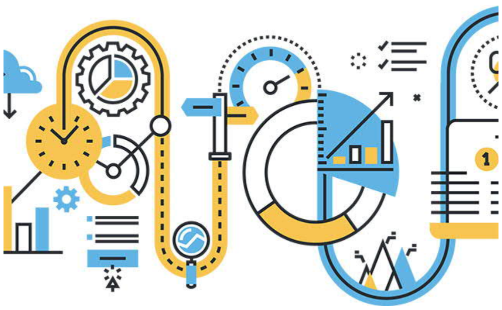

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"Can I use the R&D credit?" Many taxpayers ask this when they find out about the Sec. 41 credit for increasing research expenses (the R&D credit), one of the Sec. 38 general business credits. The R&D credit has been around since the 1980s, but it was only recently made permanent. In light of this and other favorable changes, many companies are taking a second look at this credit, and more of them than previously are finding they can claim it.

A LITTLE HISTORY

Historically, the R&D credit could only be used to reduce regular tax above tentative minimum tax. If a taxpayer's regular tax liability was less than its tentative minimum tax, it would pay alternative minimum tax (AMT) and would not be able to utilize the R&D credit or any other Sec. 38 business credits. It was a very limiting situation for many companies, especially flowthroughs.

In response to the economic crisis that hit in late 2008, Congress passed the Small Business Jobs Act, P.L. 111-240 (SBJA), to help temporarily alleviate some of the financial strain companies were feeling. Among its numerous provisions, the act reduced tentative minimum tax to zero for Sec. 38 business credits for eligible small businesses, but just for the 2010 tax year. Because many taxpayers—particularly small businesses—frequently pay AMT, the reduction of tentative minimum tax to zero was an incredible boon to businesses that could not otherwise have benefited from these credits. In fact, once the SBJA went into effect, the authors' firm saw a 30% increase in the number of taxpayers that were able to immediately benefit from the R&D credit. However, this applied to only one year. When 2010 ended, so did this provision, and many companies saw their utilization problems return.

ENTER THE PATH ACT

In 2015, the Protecting Americans From Tax Hikes (PATH) Act, part of the Consolidated Appropriations Act, 2016, P.L. 114-113, made the R&D credit permanent and along with it introduced provisions for utilization very similar to what the SBJA provided for 2010. The PATH Act provides that, for tax year 2016 forward, "eligible small businesses" may apply the R&D credit against AMT. Under both the SBJA and the PATH Act, eligible small businesses are not limited to what many may traditionally consider to be small businesses.

Eligible small businesses under both the SBJA and the PATH Act include partnerships, sole proprietorships, and non-publicly traded corporations with no more than $50 million in average annual gross receipts over the preceding three tax years. So, even a company with $49 million in average annual gross receipts is still considered "small" for these purposes.

The primary difference between the SBJA and the PATH Act is that, while the SBJA's AMT exemption applied to all Sec. 38 business credits, the PATH Act's AMT exemption is limited to Sec. 41 R&D credits. Because the PATH Act's exemption is more limited, it is easily overlooked. Practitioners and tax preparers should be sure to recognize that it does exist and that it can make a big difference to small businesses.

A FEW MORE ADVANTAGES

Those PATH Act provisions help taxpayers with taxable income utilize the R&D credit. However, companies just starting out may not have any taxable income yet, even though they may be doing a lot of R&D. Are they out of luck? Before the PATH Act, they may have been. However, another important provision of the PATH Act is its allowance of the R&D credit against payroll taxes for qualified small businesses. It is important to note that a "qualified small business" is not the same as the "eligible small business" described above.

A qualified small business is a taxpayer with less than $5 million in gross receipts for the credit year and whose first year of gross receipts was not more than four years prior to the credit year. Thus, for 2016 tax returns, a taxpayer is a qualified small business if it did not have gross receipts prior to 2012, and its 2016 gross receipts are below the $5 million threshold. This is a fantastic provision for startups, as it allows them to quickly benefit from the R&D credit even if their taxable income is still relatively small. Previously, startups that chose to take the R&D credit would often have to carry it forward several years until they had taxable income *and* had exhausted the net operating loss carryforward that many startups accumulate in their infancy.

The ability to apply the R&D credit against payroll tax also allows the taxpayer to be more certain that it will be able to use the R&D credit. Previously, a taxpayer that did not generate enough taxable income to fully use the credit could carry the unused amount back one year and forward as many as 20 years. However, when a relatively young company could generate a credit, its management might struggle with the decision of whether to hire a consultant to perform an R&D study if the taxpayer's forecasts projected that it would likely be unable to utilize the credit for several years—and risk-averse management might fear that using the credit could take even longer. Under the PATH Act, management can elect to apply up to $250,000 of the credit against the employer's Social Security portion of quarterly Federal Insurance Contributions Act (FICA) taxes, beginning in the first calendar quarter that begins after the taxpayer files the return. Any credit that is not used is carried forward to subsequent quarters indefinitely until it is exhausted. Also noteworthy is that although the credit may completely wipe out a taxpayer's applicable portion of FICA taxes, the taxpayer may still take a payroll tax deduction on its income tax return as if it were paying those taxes in full.

Additionally, qualified small businesses have the option of electing to apply the R&D credit against only payroll tax or against only (regular) income tax, or apportioning it between both. For example, a taxpayer that has a $300,000 credit may elect to apply $250,000 against the payroll tax and $50,000 against income tax.

In short, the PATH Act has not only made the R&D credit permanent, it has also made it more usable and accessible than ever before. It is important for tax practitioners advising taxpayers, particularly small and startup businesses, to keep in mind the opportunities these legislative changes have brought about.

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