Anchin Alert

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The Tax Cuts and Jobs Act Doesn't Cut the R&D Tax Credit

On December 22nd, President Trump signed the Tax Cuts and Jobs Act of 2017 ("TCJA") into law, setting the stage for the most sweeping update to the U.S. tax code since 1986 tax reform enacted under President Reagan. The centerpiece of the TCJA, is a permanent reduction in the corporate tax rate from approximately 35% to 21%.

Thankfully, as expected, the final law has preserved the research and development ("R&D") tax credit, which was made permanent in the Protecting Americans against Tax Hikes ("PATH") Act of 2015. While there are no direct changes to the R&D tax credit, there are four major ways that this tax legislation will directly or indirectly affect the taxpayers claiming R&D tax credits. To summarize, the TCJA of 2017: 1) repeals the corporate alternative minimum tax ("AMT") while retaining and adjusting the individual AMT, 2) makes significant changes to the orphan drug ("OD") credit, 3) repeals the Section 199 Domestic Production Activities Deduction, and 4) for tax years beginning after December 31, 2021, will require companies to amortize IRC Section 174 R&D expenditures over a five-year period, instead of allowing immediate expensing of those costs.

AMT - Corporate Repealed, Individual Retained and Adjusted

The final law reduces the corporate tax rate to 21% and repeals the corporate AMT. How does this change impact companies claiming the R&D tax credit? It removes the AMT restriction on corporations which has long prevented them from utilizing R&D tax credits to offset regular tax liability. For small and mid-sized companies, the new law does not have an impact, because qualified small businesses (< $50 million gross receipts) received an AMT waiver in the PATH Act of 2015.

The final law retains the individual AMT with temporary increases in both the exemption amount and the phase out threshold. Exemption amounts are increased to $109,400 for joint filers and $70,300 for other filers. The phase-out thresholds are increased to $1 million for joint filers, and $500,000 for all other taxpayers (other than estates and trusts). This will decrease the number of households subject to the AMT.

Orphan Drug Credit

Congress passed The Orphan Drug Act in 1983 to provide a more lucrative incentive for companies that are willing to embark on the development of orphan drugs. An orphan drug is a drug developed to specifically target diseases that affect only a small percentage of the U.S. population (less than 200,000 people), also known as an orphan disease. Instead of calculating the benefit for orphan drug development using the rules under IRC section 41 for the R&D tax credit, the Orphan Drug Act provided for a tax credit of 50% of clinical testing expenses ("CTEs") under IRC Section 45C. Under this new tax law, the OD tax credit will be dramatically reduced to 25% of a company's costs related to clinical trials for developing rare disease treatments.

Repeal of Section 199 - Domestic Production Activities Deduction

The TCJA of 2017 has repealed Section 199 effective for tax years beginning after December 31, 2017.

Section 199 may still be claimed for any open tax years beginning before January 1, 2018. Accordingly, taxpayers with production or service activities that are within the scope of Section 199 should consider claiming the Section 199 deduction for current years or possibly reviewing claims made in prior tax years and filing amended returns where applicable.

Research Cost Amortization

With the newly enacted legislation, for tax years beginning after December 31, 2021 taxpayers will be required to treat research or experimental expenditures as chargeable to a capital account and amortized over five years (15 years in the case of foreign research) and Section 174 will be modified to require that all software development costs be treated as research or experimental expenditures. The law's five-year amortization requirement could have a dramatic effect on taxpayers currently deducting their research or experimental expenditures under Section 174. Taxpayers with significant foreign research will feel an even greater impact, as the provision provides a much longer recovery period for foreign research.

For more information, please contact Yair Holtzman, Partner and Practice Leader of Anchin's Research and Development Tax Credits & Incentives Group at 914.860.5599 or via email at yair.holtzman@anchin.com.

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