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Permanent R&D Tax Credit: A Game Changer for America's Businesses

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R&D

Yair Holtzman of Anchin, Block & Anchin writes that more taxpayers are eligible to claim R&D credits with enactment of the PATH Act, and the credit's new permanence offers certainty in planning research investments. ''Facilitating a permanent R&D tax credit is critical to catalyzing U.S. innovation, because it provides U.S. companies with certainty as they compete in the increasingly challenging global market,'' he writes.

Permanent R&D Tax Credit a Game Changer for America's Businesses

By Yair Holtzman

President Barack Obama Dec. 18, 2015, signed into law the Protecting Americans From Tax Hikes (PATH) Act of 2015 (Division Q of Pub. L. No. 114-113). This legislation retroactively renews and makes permanent a collection of expired tax provisions for both businesses and individuals, commonly referred to as ''tax extenders.''

The tax credits and deductions made permanent by the legislation include the research and experimentation (R&E) tax credit, the child tax credit, the American Opportunity Tax Credit, the earned income tax credit, the above-the-line deduction for teachers who buy school supplies and the tax code Section 179 deduction.

The R&E tax credit, also known as the research and development (R&D) tax credit, is considered the largest single item in the package, with a cost of approximately $113 billion over 10 years. Facilitating a permanent R&D tax credit is critical to catalyzing U.S. innovation, because it provides U.S. companies with certainty as they compete in the increasingly challenging global market.

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In addition to making the credit permanent, the PATH Act is a game changer for a large number of taxpayers that have been unable to take advantage of the credit previously:

- First, the legislation allows small businesses to take the R&D tax credit against their alternative minimum tax (AMT). The AMT restriction has long been preventing qualified companies from utilizing the research credit, so this new legislation will remove that hurdle for any qualified company with less than $50 million in gross receipts.

- Second, PATH allows startup businesses with gross receipts of less than $5 million to take the R&D tax credit against their payroll taxes (essentially making it a refundable credit for up to five years).

Both of these changes are effective for taxable years beginning after Dec. 31, 2015.

The R&D tax credit benefits U.S. manufacturing and engineering companies that develop new or improved products or processes through technical activities that lead to an elimination of design or development uncertainty. The credit is applicable not only to revolutionary innovations but evolutionary advances as well.

Numerous industry segments can benefit, including semiconductors, software, aerospace, life sciences, engineering, energy, chemicals, apparel, food science and

architecture to name a few. Increasingly, business management teams are recognizing the importance of taking advantage of this generous incentive as a powerful weapon for remaining competitive, refueling their critical innovation engines and lowering their effective tax rate.

Once qualifying projects are identified, a business can offset some of its expenses associated with the initiative, including certain employee wages, as well as some testing supplies and contract research or consulting expenses. Correctly calculating and documenting the R&D tax credit is critical to maximizing both the financial benefit and sustainability of every claim.

Temporary Since 1981

Congress first enacted the research and development tax credit in 1981. However, Congress made it temporary in order to reduce the immediate budget costs.

When it was first passed, the tax credit was the most generous in the world. But as other countries have appreciated the importance of attracting R&D talent and investment, the relative strength of the U.S. research credit had declined. It is estimated that prior to making the research credit permanent, the U.S. ranked 27th out of 42 countries in the value of the credit to the business community.

Since original passage, the credit has been extended 16 times.

Making the R&D tax credit permanent has three positive effects. The first is that companies can now benefit from certainty in calculating the after-tax cost of R&D investments. They have often had to commit to investments long before they know for sure whether the credit would be extended and what form it would take.

The second is that it will make the U.S. R&D tax credit more robust and competitive with other global R&D tax credit regimes.

The discontinuous extension of the 50 or so tax provisions for one or two more years and finding ways to pay for them has consumed a tremendous amount of Congress's time each year and has proven a highly inefficient process. Decoupling the R&D tax credit from these other tax provisions, by making it permanent, will prove extremely valuable.

Furthermore, there is a great deal of economic research showing that the credit has a significant catalytic effect on the amount of research that private companies conduct in the U.S. In 2012, the Obama administration concluded that each dollar of forgone tax revenue through the credit causes firms to invest at least a dollar in R&D.

Technological innovation is the primary engine of long-term economic growth, and R&D serves as the catalyst of innovation. The federal government encourages businesses to invest in R&D in several ways. The R&D tax credit for increases in spending on qualified research above a base amount is one of the primary drivers to refuel that R&D engine. The permanency of the R&D tax credit should further catalyze accelerated innovation in the U.S.

Lastly, in making the R&D tax credit permanent, Congress will make it easier to pass comprehensive tax reform.

PATH Act Adds Value to R&D Credit

The permanent R&D credit enacted as part of the PATH Act includes new features that increase the ability for taxpayers to benefit from a claim:

- The permanence of the credit offers certainty in planning R&D activities.
- Small businesses may now use R&D credits against alternative minimum tax.
- Startup businesses with gross receipts of less than $5 million may take the R&D credit against payroll taxes.

Qualifying Activities

The federal R&D tax credit was first introduced by Congress in 1981 to reward U.S. companies for increasing spending on R&D within the U.S. The R&D tax credit is available to businesses that design or develop new, improved or technologically advanced products, processes, principles, methodologies or materials.

In addition to ''revolutionary'' activities, in some cases the credit may be available to companies that have performed ''evolutionary'' activities, such as investing time, money and resources toward improving products or processes.

In order for an activity to qualify for the federal R&D tax credit, the taxpayer must show that it meets all the requirements for ''qualified research'' as described in Section 41(d) of the Internal Revenue Code:

- The purpose of the activity or project must be to create new (or improve existing) functionality, performance, reliability or quality of a business component. A business component is defined as any product, process, technique, invention, formula or computer software that the taxpayer intends to hold for sale, lease, license or actual use in the taxpayer's trade or business.

- The taxpayer must intend to discover information that would eliminate uncertainty concerning development or improvement of the business component. Uncertainty exists if information available to the taxpayer doesn't establish the capability to develop or improve, the optimal method of development or improvement, or the appropriate design of the business component.

- The taxpayer must undergo a systematic process of experimentation designed to evaluate one or more alternatives for achieving a desired result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. Treasury regulations provide some guidance, defining this process to include something as formal as conventional implementation of the scientific method to something as informal as a systematic trial and error process.

- The process of experimentation used to discover information must fundamentally rely on principles of the physical or biological sciences, engineering or computer science. A taxpayer may employ existing technologies and may rely on existing principles of the

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physical or biological sciences, engineering or computer science to satisfy this requirement.

Conversely, the following activities don't constitute qualified research as defined in Section 41(d):

- research conducted after the beginning of commercial production of the business component;
- adaptation of existing business components;
- duplication of existing business components;
- reverse engineering;
- surveys, studies, activity relating to management function/technique, market research, routine data collection or routine testing/quality control;
- foreign research conducted outside the U.S., the Commonwealth of Puerto Rico, or any possession of the U.S.;
- research related to social sciences, arts or humanities;
- research to the extent funded by any grant, contract, government entity or person.

Contemporaneous Documentation

In order to properly claim federal R&D tax credits, a participating company must provide contemporaneous documentation that links its employees' time directly to qualifying projects or activities. There are two acceptable methods for providing this documentation—a project approach and a departmental approach.

The project approach relies on a taxpayer's time-tracking documentation to directly link an employee's hours logged to a specific qualifying R&D project. The departmental approach relies on oral testimony, contemporaneous engineering documentation, job descriptions, educational background and other information to arrive at a reasonable time estimate.

Eligible expenses, as defined in Section 41(d), are:

- wages paid to employees for engaging in qualified research, directly supervising qualified research or supporting qualified research;
- supplies directly linked to qualified research activities, including testing materials and prototypes;
- contract research performed by a third party on behalf of the taxpayer—the taxpayer must retain rights in intellectual property and financial risk unrelated to research success, and these expenses are included at 65 percent of actual taxpayer expense; and
- basic research payments made to qualified nonprofit organizations and institutions. These expenses are included at 75 percent of the actual taxpayer expense.

Competitive Factor

In conclusion, with the signing into law of the PATH Act, companies should closely examine whether they might be eligible to benefit from this tax credit. The R&D tax credit is a competitive factor for businesses in a wide variety of industries as it can lower the effective tax rate and refuel R&D efforts through increased cash flow.

Federal tax credits provide permanent benefits to reduce the cost of research and development. While claiming the credit requires time, resources and expertise, it can provide significant monetary and operational benefits to businesses. Even firms currently operating at a loss may benefit because federal R&D credits generated but not used can be carried back one year and forward up to 20 years, creating an opportunity when the firm becomes profitable.

Furthermore, allowing small businesses to take the R&D tax credit against their alternative minimum tax is a significant positive development. The AMT restriction has long prevented qualified companies from utilizing the research credits. Allowing startup businesses with gross receipts of less than $5 million to take the R&D tax credit against their payroll taxes will also enable small companies to benefit. These two changes coupled with the permanency of the research credit are truly a game changer.