HOW THE INFLATION REDUCTION ACT CAN RAMP UP R&D TAX CREDITS FOR STARTUP COMPANIES

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The Inflation Reduction Act of 2022 doubles the federal R&D payroll tax credit opportunity for Qualified Small Businesses. Taxpayers should ensure they are taking full advantage of the R&D tax credits available to them.

Introduction: the Inflation Reduction Act of 2022

In August 2022 the Inflation Reduction Act of 2022[1] was passed by Congress and signed into law. While much of the attention surrounding the more than trillion-dollar legislation has been attributed to its climate change and health care provisions, unbeknownst to many this legislation will also double the federal R&D payroll tax credit opportunity for Qualified Small Businesses (QSBs).

Prior to the Inflation Reduction Act, in 2015 the Protecting Americans from Tax Hikes (PATH) Act[2] had previously expanded eligibility for QSBs to claim R&D tax credits, while also making the R&D tax credit permanent. Most importantly, the PATH Act allowed QSBs with no income, and therefore no income tax liability, to utilize R&D payroll tax credits against the employer portion of Social Security taxes up to $8,240 per employee, up to $250,000 per year, for a total potential benefit of $1.25 million over five years.

To be eligible, a QSB must have less than $5 million in revenue for the current tax year, and less than five years of revenue since formation. QSBs can begin applying the R&D payroll tax credit against the employer portion of their Social Security tax in the first quarter after filing their return and reporting the election. The credit amount cannot exceed the taxpayer's quarterly tax liability; however, unused credits can be carried forward for up to 20 years, potentially offsetting future income tax liability. Prior to the PATH Act, small businesses without income were completely unable to currently utilize R&D tax credits, and thus were unlikely to bother claiming them only for potential use against future profits.

Starting in 2023, the Inflation Reduction Act will double the amount a QSB can potentially claim as R&D payroll tax credits, raising the available credit amount to a maximum of $2.5 million over five years. While the total maximum annual credit will double to $500,000, that amount must be applied only up to $250,000 against each prong of a QSB's payroll tax liability, namely FICA and Medicare tax. The payroll tax credit opportunity can be a life saver for small, unprofitable businesses,

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many times keeping them afloat during economic downturns such as we are experiencing now.

Following is an overview of the R&D tax credit, including examples of potentially qualifying activities and projects currently driving innovation within the life sciences industry. This article highlights the life sciences industry here because these are the companies most likely to benefit from the enhanced payroll tax credits, due to their very significant upfront research and development expenses and long pathway to profitability.

What is the R&D tax credit and how does it work?

The federal R&D tax credit under Internal Revenue Code (IRC) Section 41 was first introduced by Congress in 1981. The purpose of the credit is to incentivize U.S. companies to keep and increase spending on R&D within the United States. The R&D tax credit is available to businesses that uncover new, improved, or technologically advanced products, processes, principles, methodologies, or materials. Correctly calculating the R&D tax credit is critical for maximizing the taxpayer benefit, which will ultimately lower the taxpayer's effective tax rate and potentially generate cash flow, and for achieving sustainability in case of IRS examination.

The R&D tax credit is available to taxpayers who incur incremental expenses for qualified research activities (QRAs) conducted within the United States. The credit primarily is composed of the following qualified research expenses (QREs):

- Wages paid to employees for performing or directly supporting or supervising QRAs.
- Supplies consumed in experimentation or for building prototypes.
- 65% of contract research expenses (paid to a third party for performing QRAs on behalf of the taxpayer).
- Basic research payments made to qualified educational institutions and various scientific research organizations.

For an activity to qualify for the research credit, the taxpayer must show that it meets the following four tests, commonly referred to as the four-part test:

1. The activity must rely on the principles of hard science, such as engineering, computer science, biological science, or physical science.
2. The activities must relate to the development of a new or improved business component of the taxpayer, defined as a product or process used in the trade or business.
3. Technical uncertainty must exist at the outset of the development activities. Uncertainty exists if the information available at the outset of the project does not establish the capability or methodology for developing or improving the business component or the appropriate design of the business component.
4. Substantially all (80%) of the qualified activities must involve a process of experimentation to eliminate technical uncertainty. This process includes testing, analysis, evaluation, and design iterations – for example, assessing a design through modeling, proof-of-concept, computational analysis, or trial-and-error methodology.

Can previously filed tax returns be amended to claim R&D tax credits?

Taxpayers that were eligible for the R&D tax credit in prior years but did not claim them may file amended returns to try and claim these credits. They will now need to weigh this decision much more heavily, however, as the IRS has significantly tightened the requirements for claiming R&D tax credit refunds. This is in addition to the extra scrutiny amended tax returns may receive.

To be considered sufficient, a refund claim must now include:

- Identification of all business components, new or improved products and processes, for which the claim is based upon.
- For each business component, identification of specific research activities performed, all of the individuals who performed them, and the specific information each individual was seeking to discover.
- Total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the amended claim year – these can be included in the Form 6765 (Credit for Increasing Research Activities).

Each of these "items of information" must be submitted when the refund claim is filed, along with a declaration, signed under penalty of perjury, verifying their accuracy.

[1] P.L. 117-169, 8/16/2022.

[2] P.L. 114–113, 12/18/2015.

The importance of properly evaluating contract research expenses

Regardless of a company's size, contracting out its development activities often provides attractive benefits and lower costs than performing these development activities in-house. In order to include these expenses toward R&D tax credit claims (they are only allowed up to a maximum 65% of total expenses), a thorough analysis must be performed to determine whether the taxpayer has assumed financial risk and will maintain substantial intellectual property rights in the products or processes being developed by the contracted party. If not, the third-party contractor likely maintains such rights and is therefore entitled to claim their costs towards their own research credits.

These rights and risks need to be clearly outlined in the contracts to avoid issues regarding which entity is entitled to claim the credits. Very importantly, it is also required that all development activities conducted are performed within the United States to be eligible for inclusion in U.S. R&D tax credit claims.

Conclusion

Developing successful new drugs, better performing microchips, and more effective or efficient lab processes can be time consuming and expensive, especially for startup companies that do not have significant revenue or income to fund their efforts. Fortunately, the federal government, as well as certain state and local governments, are now providing economic incentives to help QSBs overcome such challenges.

Companies that bear the heavy burden of significant upfront, early-stage investment costs as part of new product and/or process development initiatives are being generously supported with a significantly enhanced R&D payroll tax credit opportunity. The Inflation Reduction Act of 2022 will double the financial incentive from $1.25 million to $2.5 million over five years to help QSBs offset research and development costs before these long lifecycle projects reach commercialization.

Taxpayers should ensure they are taking full advantage of the R&D tax credits available to them in order to remain competitive with their industry peers and continue innovating internally with new products, processes, and technology. Optimizing the R&D tax credit benefit includes properly identifying and documenting qualifying projects and activities as required by the IRS for sustainability upon audit. ■