GLOBALRESEARCH INSTITUTE

US RESEARCH CREDIT

R&D

Valid as at February 2022

US RESEARCH TAX CREDIT

The US research credit permanent status was unchanged under P.L. 115-97, commonly known as the Tax Cuts and Jobs Act (TCJA), and its importance continues to be recognized in the eyes of many clients. They place a high value on the credit, and they are willing to invest more into the process that they are employing to calculate and document it. However, the TCJA also contains a provision for expenditures paid or incurred in tax years beginning on or after 1 January 2022 that requires capitalization and amortization of research expenditures. Historically,

these costs have been fully deductible, or capitalizable and amortizable, at the taxpayer's option. Although there is bipartisan support for repealing or delaying the required amortization of research expenses, no legislation has been passed as of February 2022.

In the US, a nonrefundable tax credit is available under Internal Revenue Code (IRC) Section 41 for certain qualified research expenses (QREs) incurred in the US that exceed one of two computed base amounts. This tax credit may be used by a business to reduce its federal tax liability. The QREs eligible for the research credit are a subset of research and experimental expenditures as defined under IRC Section 174, as QREs are generally measured as direct expenses of R&D without including overhead expenses or indirect expenses. QREs generally include wages, supplies and a portion of contract or third-party expenses incurred within the United States.

Approximately two-thirds of the states also offer a research credit for state tax purposes. Many states model their research credit on the federal credit; however, the credit is generally permitted only for QREs incurred within the state, and the state credits can vary dramatically between jurisdictions. For example, some states do not require a business to increase its QREs (as the federal credit does) in order to receive a credit. Often the types of expenses that qualify for the credit are different, and the percentages of QREs used to compute the credit also differ. For most businesses, their federal research credits are larger than their state research credits, but that is not always the case.

Although the federal research credit had always been a temporary provision in the law requiring an act of Congress to renew it year after year, the termination provision was removed in 2015, seamlessly extending the research credit permanently for amounts paid or incurred after 31 December 2014. In addition to making the credit permanent, other changes made in 2015 to the research credit benefit "eligible small businesses" that can now claim the credit against alternative minimum tax (AMT) and other "qualified small businesses" that may apply the research credit against the employer's payroll tax liability. Generally, most state research credits continue to be permanent.

DESCRIPTION OF BENEFITS

Federal and state research credits for certain QREs incurred in the US may be used by a business to reduce its federal and state tax liabilities. These are statutory tax incentives with specific amounts and applicability defined in the statute at either the federal or state level. In general, the federal credits are nonrefundable, while some state credits are refundable. In addition, some state credits may have the potential to be purchased or sold to the benefit of the taxpayer.

The federal research credit is designed to reward a business for performing research in the United States and for increasing its spending on research; thus, a taxpayer must determine the increment of its current-year QREs over a computed base amount to claim the research credit.

Section 41 of the Internal Revenue Code provides two methodologies for computing the research credit:

- Regular credit: The regular credit is computed by measuring spending as a percentage of a business's gross receipts. Thus, if a business is increasing its QREs as a percentage of gross receipts measured against a historic period (generally 1984–88), it will likely be eligible for the regular credit. The maximum cash benefit in tax savings for the regular credit is about 7.9% of a business's QREs, but the benefit may be smaller.
- Alternative Simplified Credit (ASC): The ASC is a much simpler way to compute the research credit. Generally, the credit is equal to 14% of a business's increase in QREs in the current year, over 50% of the average QREs for the prior three years.

The net benefit of the reduced research credit that taxpayers can elect under Section 280C was indirectly increased by the lower corporate tax rate passed under the TCJA. The Section 280C reduced credit is net of the highest tax rate. Prior to the TCJA, the highest tax rate was 35%, and post-TCJA the new rate is 21%, meaning that pre-TCJA, taxpayers claiming the reduced ASC credit only recognized a tax credit benefit that equated to 65% of the research credit and now, taxpayers will recognize a

benefit that equates to 79% of the research credit, a 21.5% increase. For taxpayers claiming a reduced regular credit, they will recognize a benefit that equates to 15.8% of the research credit instead of 13%.

In general, the research credit is limited to a maximum of 25% of the regular tax liability. Unused research credits may be carried back for 1 year and carried forward for 20 years. Additionally, certain qualified small businesses may claim the credit against their federal payroll tax liability up to $250,000 annually. This is a favorable rule for certain eligible startup companies that do not have a federal income tax liability because they may be eligible to use the credit to offset up to $250,000 of their federal payroll tax liability.

GUIDELINES AROUND INCENTIVE APPLICATIONS

The research credit is applicable to retroactive investments and current investments. The research credit is claimed on the original corporate income tax return by completing Form 6765 and electing either the regular credit or the ASC. It must be filed by the due date of the return with extensions. A retroactive research credit may be filed by amending the income tax return for the open year for which the credit is being claimed. In general, taxpayers may claim the incentive retroactively for three years. The IRS has also released Form 8974 and revised Form 6765 to allow qualified small businesses to claim the credit against their federal Form 941 payroll tax liability for tax years beginning on or after 1 January 2016. For questions regarding incentive applications, please contact one of the named individuals in this document.

RESEARCH EXPENDITURES

Overview

For tax years beginning before 1 January 2022, a tax deduction was permitted under IRC Section 174 for 100% of R&D expenses for federal and state tax purposes.

However, because of 2017 US tax reform, for tax years beginning after 31 December 2021, IRC Section 174 is significantly modified. Amounts defined as specified research or experimental expenditures are now required to be capitalized and amortized ratably over a five-year period if the research is conducted in the United States. Further, expenditures attributed to research that is conducted outside the United States will be required to be capitalized and amortized ratably over a 15-year period. The amortization period begins at the midpoint of a taxpayer’s year. Therefore, the first year's amortization deduction is 10% of the amount paid or incurred in the taxable year (or 3.33% if the research is conducted outside the United States). A taxpayer cannot recover capitalized costs sooner than the end of the applicable amortization period. The amendments to Section 174 also require that all software development activities be included in the required capitalization and amortization regime under Section 174.

As noted in the introduction, there is bipartisan support for repealing or delaying the required amortization of research expenses, but no legislation has been passed as of February 2022.

ELIGIBILITY REQUIREMENTS

For the federal research credit, "qualified research" includes research for the purpose of developing new or improved “business components.” Business components are defined as products, processes, computer software, techniques, formulas and inventions, whether held for sale or lease by the taxpayer or used in the taxpayer’s trade or business. The credit is available for in-house and contract expenses incurred for qualified research.

Qualified research consists of R&D activities involving a process of experimentation designed to eliminate uncertainty in the development process. The R&D must relate to the function, performance, reliability or quality of the business component and must be based on engineering or on biological, chemical, physical or computer sciences.

Qualifying expenses for the federal research credit (and most state credits) are defined as taxable wages paid to employees directly involved in R&D, consumable supplies used directly in R&D and 65% of amounts paid to third parties for research services.

IP AND JURISDICTIONAL REQUIREMENTS

There is no specific jurisdictional requirement on the location of intellectual property (IP).

TECHNOLOGY OR INNOVATION ZONES

There are no technology or innovation zones providing R&D incentives in the US.

ROLE OF GOVERNMENTAL BODIES IN ADMINISTERING INCENTIVES

Generally speaking, the taxing authorities may audit research credits claimed by any taxpayer after the filing for the credit. Although there is no special audit or preapproval process required for the federal research credit (and most state credits, though some do require applications), there are special procedures, such as prefiling agreements (PFAs), available to taxpayers that wish to have their federal research credit audited in advance of filing their

tax returns. Additionally, in 2017, the Internal Revenue Service issued a directive to its audit teams that provided alternative guidance for calculating QREs that covers taxpayers that also expense research and development under Financial Accounting Standards Board Accounting Standards Codification Topic 730. The directive was revised in 2020. In 2021, the Internal Revenue Service issued field advice that imposes additional requirements on research credit claims made on amended returns.

ADMINISTRATIVE REQUIREMENTS

As with any credit, a taxpayer must maintain business records to support credits claimed. There are no special procedures for research credits.

STATUTORY REFERENCE

- Federal research credit: Section 41 of the IRC
- Federal R&D expenditures: Section 174 of the IRC
- State credits and R&D expenditures: various provisions based on each state's statutory framework

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