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BY EVE DREYFUSS & SHANE HUNT

R&D Tax Credit Changes Open Doors for Contractors

Since 1981, Internal Revenue Code (IRC) §41, Credit for Increasing Research Activities, known as the Research & Development (R&D) tax credit, has provided companies in such sectors as manufacturing, aerospace, pharmaceutical, and technology more than $10 billion in tax savings annually.[1]

However, until the end of 2015, the R&D credit was temporary and often only enacted for two years at a time. It would periodically expire and go unaddressed for up to 12 months until Congress would extend it. These extensions often made it effective retroactively, covering the year in limbo and possibly the following year. The constant expirations and long periods of uncertainty over its renewal made it unreliable.

After realizing that the uncertainty of the credit reduced the incentive to perform research, Congress enacted the *Protecting Americans from Tax Hikes (PATH) Act of 2015* to make the R&D tax credit a stable source of tax savings beneficial for both small and large companies in multiple industries, including construction.

Permanency Brings Big Benefits

Contractors employ highly technical civil, mechanical, electrical, and structural engineers to develop products and processes – activities that are often eligible for R&D credit. Since these activities support the construction of various projects (e.g., dams, bridges, commercial buildings, mechanical systems, electrical systems, and foundation systems), now is a great time to take advantage of the credit.

In addition to the general benefit of certainty, the extension has several substantial advantages:

Consistent Financial Reporting

One of the most significant benefits for contractors is that they can now consistently claim the R&D credit on their quarterly financial statements.

Previously, companies could not record the tax benefits in their financial statements if the credit had expired, which could cause disparities on yearly or quarterly statements. They could only include the R&D credit at the end of the year or during the first quarter of the next year after Congress had extended it and made it retroactive, if it was extended at all.

Companies can now consistently report the benefits throughout the year and do not have to make higher estimated tax payments and report less income during those periods.

AMT Limit Lifted for Small Businesses

Another PATH Act change makes it easier for smaller companies to realize R&D benefits regarding potential alternative minimum tax (AMT) liability.

Prior to the PATH Act, the R&D credit could not reduce a company's tax liability to less than the computed AMT tax liability. The new PATH Act provision removes this limit and enables the R&D credit generated by eligible companies to be used against the AMT liability – a significant change for small businesses.

For example, suppose Company A has regular taxable income of $250,000 and regular tax liability of $85,000. In comparison, under the AMT calculation, which adds certain deductions back into its tax liability, Company A has $600,000 in taxable income that results in a tentative AMT liability of $120,000. Ordinarily, Company A would have to pay the $120,000, but under the new rules, the R&D credit can reduce that amount.

For purposes of the AMT limitation exception, the IRC defines small businesses as any privately held corporation, partnership, or sole-proprietorship whose average annual gross receipts for the previous three-year period are $50 million or less.

For partners and S corporation shareholders, the three-year average annual gross receipts limit applies to business income from all sources. Gross receipts calculations (reported on Line 1c of the company's federal income tax return) determine if a company or individual is eligible for an AMT limitation exception.

Although the revenue limitation helps to define a company's eligibility for the credit, it is important to note that the actual credit a company receives is not calculated based on its revenues, but rather on its eligible R&D expenses.

Since the provision applies starting in 2016, the first three-year qualifying taxable period would be 2013-2015. The credit must be calculated and shown on a taxpayer's 2016 federal income tax return, and the portion of the R&D credit that will be used in 2016 must be reported on Form 3800 (General Business Credit). Any unused credit may be carried back one year or forward 20 years, if conditions are met.

Start-Ups Get a Boost

The PATH Act also addresses concerns from newer companies. During a company's start-up phase, significant expenses are incurred with the goal of developing new products and processes that will generate future revenue and taxable income. Even though a company isn't paying federal income taxes, it may be paying a significant amount in payroll taxes.

A new provision[2] allows qualified small businesses (those with less than $5 million in gross receipts and no more than five years of gross receipts) to allocate up to $250,000 of federal R&D tax credits generated after January 1, 2016, to offset the FICA portion of their payroll taxes. This is a big change, considering that previously the credit could be used only against income tax liability.

Now, a company starting operations in 2016 can reduce its payroll taxes by up to $250,000 per year for five years as long as its gross receipts are less than $5 million and its payroll exceeds $4 million.

Specialized contractors can also make use of the credit. For example, smaller companies designing and developing mechanical, electrical, plumbing, or drainage systems could take advantage of the new payroll offset if they are performing R&D activities.

Companies that didn't have gross receipts prior to 2012 may now be able to claim the credit and reduction in payroll taxes. The R&D credit would be calculated on the 2016 tax return as usual, but the taxpayer has the opportunity to claim the payroll portion starting the quarter after the credit is claimed on the federal tax return. In other words, the earliest that payroll taxes can be reduced is July 2017.

Authors' Note: The IRS and Treasury Department have been instructed to create new regulations to provide further guidance on the definition of revenues for purposes of treating the R&D credit as a specified credit. While the timing of the release is still unknown, these new regulations should also provide guidance on other provisions related to the rules and overall implementation of the credit.

Determining Eligibility

Although the previous provisions have specific eligibility requirements, all companies are eligible for the general R&D credit if they conduct R&D as defined by the law. All research activities must be performed in the U.S. Eligibility is defined by rules, regulations, court cases, and other guidance, but a simplistic determination of activities that would qualify for the R&D tax credit is laid out in this Four-Part Test:

- *Technical uncertainty* – The activity is performed to eliminate technical uncertainty about the development or improvement of a product or process, which includes computer software, techniques, formulas, and inventions.
- *Process of experimentation* – The activity includes some process of experimentation undertaken to eliminate or resolve a technical uncertainty. This process involves an evaluation of alternative solutions or approaches and is performed through modeling, simulation, systematic trial and error, or other methods.
- *Technological in nature* – The process of experimentation relies on the hard sciences, such as engineering, physics, chemistry, biology, or computer science.
- *Qualified purpose* – The purpose of the activity must be to create a new or improved product, technique, formula, invention, or process (computer software included) that results in increased performance, function, reliability, or quality.

Calculating the Credit

The qualified research expenses used to calculate the R&D tax credit is a combination of employee wages, supplies, and subcontractor expenses:

- Qualified wage expenses include the wages of employees who directly conduct, support, or supervise the R&D activities.
- Qualified supply expenses generally consist of materials used to conduct qualified research.
- Qualified contract research expenses include work by non-employees (e.g., subcontractors) whose work would qualify if self-performed by the company. The company must be at risk for the non-employee's work and retain substantial rights in the results of the work performed. Qualified contract research expenses are generally limited to 65% of the amount paid to a contractor.

In our experience, generally the benefit of the R&D credit is approximately 4-8% of a company's eligible R&D expenses.

For example, a company with $600,000 in qualified research expenses would have a credit of approximately $39,000. In comparison, a company with $3 million in qualified research expenses would have a credit of approximately $195,000. Ideally, the entire credit can be used in the current tax year, but a tax professional should advise on each situation.

Courts Clarify Eligibility & Risk

While the PATH Act has introduced new legislation impacting the usability of the R&D credit, recent court cases have provided clarification on which expenses are eligible, as well as how to treat contracts.

First, cases have answered a key question: When performing work for another party, what R&D activities are eligible to receive the R&D tax credit?

As the Florida Southern District Court ruled in *Geosyntec Consultants, Inc. v. United States* in 2013, the party that bears the risk of financial loss is the one that is eligible to receive the credit. In this case, contractors performing research under fixed-price or lump-sum contracts were considered eligible, while contractors performing research under time and materials and certain cost-plus contracts were considered funded, and therefore ineligible.

This was not the only case to rule that work classified as funded is not considered to bear the risk and therefore ineligible for R&D credits. In ***Dynetics, Inc. v. United States***, the U.S. Court of Federal Claims held that the taxpayer was not eligible for the R&D credit because the research performed by the taxpayer was "funded research" due to the fact that payment was not contingent on the success of the research and in certain instances the company did not retain substantial rights to the research results.

Recent court cases have also provided guidance on how to approach contracts, with particular focus on treatment of subcontractor expenses. When companies claim subcontractor expenses as part of their qualified R&D expenses, it's critical for them to show that they are bearing the financial risk of their subcontractors' work. Even if the work performed by the subcontractor leads to an unsuccessful R&D outcome, payment by the contractor for the work performed may show that the contractor was at risk for the activities performed by the subcontractor.

When the work performed by a subcontractor is one of many components related to the contractor's overall R&D effort, the contractor may still retain risk in the integration of the different components. The risk of integration of all design components by the contractor is supported by ***Trinity Industries, Inc. v. United States***, where the Fifth Circuit Court of Appeals ruled that a risk of failure exists with the contractor that is integrating components into a larger R&D effort.

It's Time to Investigate Eligibility

Although they may not have taken full advantage of the R&D tax credit in the past, many contractors may be ideal candidates now that the new changes aim to provide more clarity for financial statement reporting, greater opportunities for newer companies, and less AMT liability for small businesses.

If your company is performing R&D activities for new and innovative products or processes, it's worth investigating how it might benefit from the R&D tax credit. ■

Endnotes

1. *www.irs.gov/uac/soi-tax-stats-corporation-research-credit.*
2. IRC §41(h).

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