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The New 2007 “Simplified” R&D Tax Credit...Why Thousands of More Companies Will Qualify!

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So, let's say that in a prior year, you tried desperately to take advantage of the U.S. R&D credit. You ran some numbers, only to conclude that there were just not enough qualifying research expenditures (QREs) to exceed the base amount needed for there to be any benefit.

What do you do now?

I'll tell you what. DON'T QUIT! DON'T GIVE UP! REVISIT NOW!

THE GAME IS CHANGING! THE U.S. R&D CREDIT IS GETTING BETTER AND BETTER AND THERE IS AN EXCELLENT CHANCE YOU COULD QUALIFY FOR THE CREDIT IN 2007!!!!

And, you'd better be talking to your clients about this now before they learn about it from your friendly competitor. They are gearing up this summer with value added ideas to turn their prospects (your clients) into new clients!

Let's go back to December 20, 2006. The Tax Relief and Health Care Act of 2006 was signed into law. It extended the R&D credit, retroactive to January 1, 2006, for two more years. It also enhanced the alternative incremental research credit (AIRC) rates. And thirdly, and the focus of this article, is that it created a new method, as of January 1, 2007 to calculate the research credit called the alternative simplified credit (ASC).

The new ASC credit equals 12% of the excess of current year QREs over 50% of the average QREs for the prior three years. For start up taxpayers, the credit would equal 6% of current year QREs. The election to use this method would apply to subsequent years unless revoked with the consent of the Secretary of Treasury.

So, why did they come up with this new “simplified” credit? Who does it help? How does it work?

The “why” question is easy. Congress wants more and more companies to be eligible for the U.S. R&D tax credit. The R&D credit is not new. It started in 1981. Initially, the qualifications were tough to meet. When Congress discovered that U.S. companies were sending their research to Canada and overseas to countries with liberal R&D tax credit laws, they knew the U.S. law had to change.

New regulations were finalized in January, 2004 broadening the tax definition of R&D. Many more companies, not just high technology companies, then qualified for the credit. Now again, beginning in January 2007, Congress recognized that the antiquated base year calculation had to be expanded. A new credit calculation was necessary to account for different business structures and changing economic circumstances. So, they sweetened the pot so more companies would qualify.

Who does this help? It helps: a) companies who previously did not have enough QREs to exceed the base amount. This can happen if a company’s sales have increased significantly, b) a company that enters into a new line of business that generates gross receipts but performs little R&D, c) a company that spends less to perform the same amount of R&D because it becomes more efficient in its R&D process, d) a company that has a significant increase in QREs in the current year (under the regular credit calculation, the credit could not be claimed on more than 50% of the current year QREs. This 50% rule does not apply to the simplified credit calculation), and e) those companies having difficulty determining their regular fixed base year percentage due to lack of substantiation for the base period years 1984 – 1988.

The major difference is that the regular credit base amount calculation is tied to gross receipts. Specifically, you multiply a fixed base year percentage by the average of the prior four years of gross receipts. If during the past four years the company was growing and sales increased, the base amount is getting higher. If the QREs have stayed more constant, then the difference between the current year QREs and the base is smaller or even non-existent.

The new 2007 “simplified” method calculates the base entirely different. No longer is the base tied to prior year gross receipts. Instead, the base equals 50% of the average prior three years of QREs. This is a very dramatic change! Let’s look at an example for clarity.

See the calculation of the credit using the regular method and the simplified method for ABC Company. The company sales have increased approximately 10% each year for the past four years.

Under the regular credit method, there would be no credit generated for 2007 since the current year QREs of \$1,300,000 do not exceed the base amount calculated at \$1,387,500. But, look at the dramatic difference with the simplified credit method. The current year QREs of \$1,300,000 exceed the base amount, \$550,000 by \$750,000. This incremental difference, multiplied by the simplified credit rate of 12% equals a credit of \$90,000!

That’s a BIG difference! And, you may not have to wait until you file the 2007 tax return to take advantage of this credit. If you have good facts, this might change your 2007 estimated tax payments beginning with your next quarterly estimate due June 15, 2007.

Conclusion

The addition of the “simplified” credit will allow many more companies to qualify for the U.S. R&D credit. It’s a strong sign by Congress that they want technology to stay in the U.S. In addition, on the very first day of the New Congress in January, 2007, Senator Baucus introduced legislation to make the R&D credit permanent. It appears that there will be continued strong support for the U.S. R&D credit in the future.

What does this mean for CPAs? It means they should get on the bandwagon and be proactive with this credit. It's going to be an ever increasing, key material component of tax returns and financial statements. CPAs should develop a keen understanding and working knowledge of this credit. They should discuss the R&D credit immediately with their clients and it should be included on their 2007 mid-year tax planning meeting agendas. It should even be considered before making 2007 quarterly estimated tax payments.

At the end of the day, CPAs will have a choice. Either they will bring up the R&D topic with their client, or someone else will. And, that someone else could very well be their friendly competitor.

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<u>2007 Regular vs. Simplified R&D Credit Example</u>					
ABC Company					
Year	2003	2004	2005	2006	2007
Gross Receipts	40,000,000	44,000,000	48,000,000	53,000,000	58,000,000
QREs	900,000	1,000,000	1,100,000	1,200,000	1,300,000
Fixed Base Year %					3%
#1 - Regular Credit Calculation for 2007					
Current Year QREs					1,300,000
Less: Fixed Base Year % x Average of prior 4 years of gross receipts				= 3% x 46,250,000 =	<u>1,387,500</u>
Difference					0
Regular R&D Credit %					20%
Regular R&D Credit					<u>\$ -</u>
#2 - Simplified Credit Calculation for 2007					
Current Year QREs					1,300,000
Less: 50% x Average of prior 3 years of QREs = 50% x 1,100,000				=	<u>550,000</u>
Difference					750,000
Simplified R&D Credit %					12%
Simplified R&D Credit					<u><u>\$90,000</u></u>