THE R&D TAX CREDIT: PERMANENT, EXPANDED AND OPEN TO STARTUPS AND SMALL BUSINESS

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In all of the talk surrounding the $600 billion plus tax bill signed into law by the president last month, an underreported change within the deal could have the greatest impact of all for U.S. businesses. We are of course referring to the changes made to the Research and Development (R&D) Tax Credit, which was not only made permanent as part of the Protecting Americans from Tax Hikes (PATH) Act of 2015, but also includes two key adjustments that will greatly expand the number of businesses able to take advantage of the credit.

Last year alone, the R&D Tax Credit provided over $10 billion in tax savings to U.S. companies. Taking into account the enhancements made to the credit, enhancements that were designed to allow startups and small businesses previously barred from the credit to now claim its tax benefits just as larger corporations currently do, it is estimated that the research credit could provide an additional $2 billion to U.S. businesses.

Considering the value on the table for U.S. companies, CPAs and tax practitioners should be getting in front of their clients now to discuss this tremendous opportunity to grow their businesses. To understand the full ramifications of the new and improved R&D Tax Credit, let's explore three modifications in detail: (1) permanency, (2) the turn-off of the AMT bar and (3) the new startup provision.

1. PERMANENCY

To begin, let's start with those companies that were already claiming the credit, and what certainty can mean for tax practitioners and CPAs when planning for the future. Since its introduction over three decades ago, the R&D Tax Credit has, until now, been a temporary business credit. Although the credit has been renewed and its reach expanded multiple times, the constant (and often deadline-driven) extensions have prevented companies from being able to truly strategize the future of their businesses around its availability.

Since the beginning, the R&D Tax Credit was designed as a financial incentive for innovative companies that were investing time, money and U.S.-based man hours into improving their products and processes. And while the words "R&D" may bring to mind the kind of research taking place in a lab, the credit is also very much about rewarding applied science as well—the steps taken to make a product or process cheaper, cleaner, faster, greener or more efficient. The credit was intended not only to reward this kind of technical problem solving, but to ensure businesses continue to invest in new and improved products and processes for years to come, while keeping well-paying technical jobs on U.S. soil.

As most business owners will tell you however, it is very difficult for them to plan and invest in future endeavors (and in this case, R&D endeavors) if they are unsure what the laws and regulations are going to be beforehand. Now, with respect to the R&D Tax Credit, those worries are a thing of the past. With permanency comes certainty, and businesses will now be able to tailor their future processes and investments knowing full well the credit will be around to offset the costs.

2. AMT TURN-OFF

Now, let's move to the expansions—starting with the AMT turn-off.

OLD POLICY SHORTCOMINGS

In the past, the greatest hurdle preventing small and medium businesses from claiming the R&D Tax Credit was the alternative minimum tax (AMT) bar provided in section 38(c) of the tax code. As tax advisors working in this area will tell you, the AMT barrier has long prevented owners of pass-through entities from using the research credit to reduce their taxes below their tentative minimum tax (TMT).

Let's take a basic example—if business owner Bob was paying AMT in tax year x, he could not take the R&D Tax Credit for tax year x. If Bob was paying regular tax (and paying no AMT because his regular tax was above his TMT), he could reduce his tax liability, but only to his TMT level. So, in effect, a business owner would often get little to no benefit when filing for the research credit.

Many tax advisors have found that it is a good idea not to have any breakable objects within arm's-reach of a client when explaining that yes, the client has engaged in activities that make them eligible for the R&D Tax Credit, but no, the client cannot use the credit to reduce his or her taxes this year (or only a much reduced portion of the taxes) because of the limitations of section 38(c). And, of course, this impacts Bob's views on whether and to what extent he invests in future innovation.

Given that a strong majority of small and medium businesses are organized as pass-through entities (the owners of which are often subject to AMT), the reality of the AMT bar has been that tens of thousands of businesses are effectively prevented from taking full advantage of the credit. In our experience, under the old law, the vast majority of businesses that we talk to that would have qualified for the R&D Tax Credit could not utilize it due to the AMT bar in section 38(c).

POLICY SOLUTIONS

In an effort to address this shortcoming and to provide an incentive to innovate while providing tax relief for small and medium businesses, the law was changed starting in 2016. The recently passed tax extenders bill effectively turns off the AMT bar for "eligible small businesses" (defined by the PATH Act as businesses with less than $50 million in average gross receipts for the prior three years) that otherwise qualify for the R&D Tax Credit.

When it comes to calculating the credit, the tentative minimum tax is treated as being zero for those qualifying companies defined as "eligible small businesses," meaning they can use the credit to offset within parameters both regular and alternative minimum tax liability. The policy is very similar (although with some technical differences that we would highly recommend you review with a qualified tax advisor) to the AMT turn-off that was implemented as part of the Small Business Jobs Act of 2010. That year, we saw firsthand the game-changing impact this provision had in helping keep the doors open for businesses in the midst of a then challenging economy. With the removal of the AMT barrier, we foresee a similar positive economic impact, and estimate a ten-fold increase in the number of small businesses that can utilize the R&D Tax Credit.

3. STARTUP PROVISION

Now, on to the startup provision.

For years, one of the real oddities of the R&D Tax Credit was that many of our nation's most innovative companies were unable to claim the credit as they were just opening their doors. Taking into account that the majority of startups are not immediately profitable, and thus pay no federal income taxes, it follows that the majority of our nation's most cutting-edge companies were essentially barred from a credit designed to reward business ingenuity—clearly, an obvious disconnect from the intent of the credit to its real-world application. And this disconnect occurred at the most sensitive time of a company's life cycle, its nascent phase when every dollar is most essential.

An important amendment—the startup provision—changes all of that. Now, starting in 2016, startups (defined by the legislation as businesses with gross receipts of less than $5 million a year) will be able to take the credit, capped at $250,000 against certain payroll taxes, beginning in 2017. This is obviously big news for software and technology companies that, due to the innovative nature of their work, are among the best candidates for the R&D Tax Credit.

To show the provision in practice, let's take a real-world example. One software development company whose

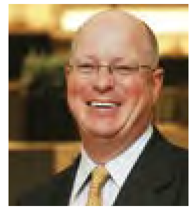
R&D activities alone would have qualified them for around $100,000 in federal credits was unfortunately barred from their projected federal tax savings, largely a result of the company simply not being around long enough to generate profits for taxable income.

However, under the new provision, this same company with an annual payroll of $1.75 million, that also pays $108,500 in payroll taxes, would be able to use the credit to reduce their payroll taxes down to $8,500. The net gain, $100,000 in added tax savings, could be reinvested in any way the business deems fit.

IMPACT ON CPAS AND TAX ADVISORS

As you can see, the benefits of this legislation regarding the research credit are massive. Quite frankly, this is probably the biggest news on taxes for startups and small businesses in years, and tax practitioners with clients in fields as diverse as computer software, pharmaceuticals, chemistry, biology, nanotechnology, robotics, energy, engineering, architecture, construction, manufacturing, food processing, and agriculture (and that's just to name a few) should take a second look when evaluating their clients' eligibility for the credit.

Now, it is up to CPAs and tax consultants to ensure their clients are taking advantage of every opportunity afforded under the R&D Tax Credit. a



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