Maximizing the R&D credit: Four recent changes for tech companies to consider

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Recent changes may allow taxpayers to finally claim the credit for research or increase the credit previously claimed.

The Credit for Increasing Research Activities ("R&D credit") can be a great opportunity for technology companies to reduce tax liability and fund future developments through reinvestment of tax savings. Enacted in 1981, the R&D credit is intended to encourage and reward American taxpayers for innovation in developing and manufacturing products and providing technical services. However, the credit initially favored larger, more sophisticated taxpayers that had the infrastructure to track and document research expenses and that paid sufficient tax to utilize the credit.

Changes to credit-related legislation have sought to ensure the credit continues to promote investment in domestic innovation. Despite these developments, the R&D credit was still difficult for some companies to claim, for a few reasons: ambiguity related to the qualification of certain types of activities, limitations on the inclusion of certain types of research expenses and lack of avenues for innovative companies to benefit from the credit in their early years. More recent changes – including the introduction of a payroll credit, the ability to offset Alternative Minimum Tax ("AMT"), the newly released Internal Use Software ("IUS") regulations, and the availability of the Alternative Simplified Credit ("ASC") on amended returns – may allow taxpayers to finally claim the credit for research or increase the credit previously claimed.

The recently passed Protecting Americans from Tax Hikes Act ("PATH Act") may allow taxpayers that could not benefit from the credit under prior rules to claim and utilize R&D credits. Before the PATH Act, companies could only lower the regular tax liability to their tentative minimum tax. As such, companies still in the development phase that typically do not pay income tax could not claim the credit. Additionally, small and midsized businesses often could not take advantage of the credit because of the AMT. The PATH Act provides two new methods for startups and small businesses to claim the credit. The PATH Act also made the previously temporary credit permanent, allowing qualified taxpayers to better plan for its impact.

1. Payroll offset for qualified small businesses (startups)

The PATH Act, by providing the ability to offset payroll tax liability, created an opportunity for startups to utilize the credit, even though they do not have an income tax liability. Companies that meet the qualified small business criteria can now offset payroll tax liability up to $250,000

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technology startups that often make major investments long before sales of the product generate taxable income.

Qualified small business/startup requirements include:

- Current year gross receipts total less than $5 million; and
- No gross receipts for any tax year before the five tax years ending with the taxable year for which the company wishes to claim the credit. For example, in order to claim the payroll credit for the 2016 tax year, the company cannot exceed $5 million in gross receipts in 2016 and cannot have had gross receipts prior to 2012.

Further guidance related to the payroll credit:

- There is an annual cap of $250,000. Any excess credit may be carried forward as a general business credit.
- Credit offsets Social Security tax liability for the first calendar quarter beginning after the date on which the company files its tax return.
- Any credit exceeding payroll liability is allowed as a credit for the following calendar quarter until fully utilized.

2. AMT offset for eligible small businesses

Companies paying AMT have previously been unable to utilize the credit. This disproportionality impacted small business and pass-through entities and prevented them from benefiting from the R&D credit. Starting in tax years beginning after December 31, 2015, the PATH Act allows some of these companies to offset AMT with the credit so long as they meet the definition of an "eligible small business." Eligible small businesses are non-publicly traded corporations, partnerships or sole proprietorships with average annual gross receipts for the three taxable years preceding the credit years of less than $50 million.

3. Final regulations clarify qualification of internal software spend

Many companies develop software for internal processes including manufacturing, ERP systems, customer-facing applications, and operational software to conduct or provide services. Traditionally, these were defined as IUS and were subject to a different set of qualification rules that were exceedingly difficult to meet. Additionally, while IUS-related regulations have gone through several changes over the years, the Treasury had declined to provide clarity through final regulations for more than a decade. While a court case clarified some of the rules and made it easier for taxpayers to claim IUS-related expenses, doing so remained a high-exposure item. Final regulations issued in 2016 provide structure and a process to qualify and capture IUS-related expenses.

Before the final regulations, if software was not sold, leased or licensed, it was considered IUS and needed to meet a heightened criteria to qualify. Under the final regulations, IUS no longer includes software that enables the taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system and software used in a non-G&A function. This definition change is significant: companies that develop software to interact with customers or software to assist their business in a non-administrative way can qualify for the related expenses under the standard rules. Thus, the process of qualifying and documenting the activities is much less burdensome.

Previously, a company could still qualify its IUS development activities if it met a heightened three-part test. However, this test was ambiguous. A major point of contention was the test's unclear definition of "innovative"; it ranged from something patentable to something exceeding the field of computer science. The final regulations define innovative as software that significantly improves performance, reduces waste or saves money. The new definition often closely aligns with the reason companies are developing the new software systems. As a result, the final regulation's definition of "innovative" not only removed ambiguity, but also enables companies investing resources for software development to identify these developments as innovative.

4. Amending and documenting the credit

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Until recently, if companies did not originally claim the R&D credit on their return, it was exceedingly difficult to amend prior-year returns to claim it. Companies were required to use a method that often relied on data dating back to the late 1980s. In 2014, regulations were issued allowing taxpayers to use the ASC method on amended returns. The ASC method relies on costing detail from three years prior, making it much easier for eligible companies to compute the credit for amended returns.

In light of recent changes, more companies may be able to benefit from, and maximize, their R&D credit. Yet documenting the credit continues to be complex, as it involves not only calculating the credit, but also identifying documentation that will support the qualification of activities. Companies claiming the credit should gather documentation capable of substantiating both the expenses and activities if reviewed by the IRS. However, given the recent changes, concerns regarding documenting expenses should not prevent companies that may qualify for the credit from exploring the potential benefit.

This article originally appeared in FEI Daily.

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Contact

Dan Mennel
Partner, Strategic Federal Tax Services
+1 408 216 8510

Javier Huertas
Senior Manager, Strategic Tax Services
+1 206 398 2430

Monica Bambury
Experienced Manager, Strategic Tax Services
+1 206 418 6033

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