

## Tax Notes

# It's the Golden Age to Claim the Federal Research Tax Credit

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These are the glory days for those seeking to claim the federal research tax credit. This is particularly so for small and middle market businesses and startups. The credit effectively generates a net tax savings of 13% (or approximately 9.1% under the alternative simplified method) of incremental qualified research spending. And the credit reduces tax liability dollar for dollar. Now, more than a generation after its enactment, the credit is permanent. Companies no longer need to fear that the credit won't be re-enacted every couple of years by Congress.

In particular, the credit is attractive for software, financial service, biotech and pharmaceutical, architecture, construction, engineering and manufacturing companies.

### Give Credit Where It Is Due

Small or middle market companies should not disqualify themselves. It's been estimated that annually more than \$4 billion in research tax credits is never claimed. Why? Sometimes, businesses incorrectly believe that a company cannot claim the credit if its research didn't work. Wrong. With the research credit, failure is an option.

Other companies believe that the research credit is useless to a company that isn't profitable. Nothing could be further from the truth. A company in a loss position can carry forward its credit for use in future profitable years. Further, with recently passed legislation, small start-up companies may now be able to claim a credit against their payroll tax even if they pay no income tax. Specifically, qualified startups can annually claim up to \$250,000 of the credit against their FICA payroll taxes. A qualified startup is defined as a company with less than \$5 million in gross receipts for the current year and no gross receipts for any tax year preceding the five-year period ending with the tax year (so no gross receipts prior to 2012).

Some companies believe that the credit is only for large C corporations. Incorrect. S corporations, partnerships, and LLCs of all sizes are eligible. The credit flows through to the entity's owners or partners.

Still others question whether entities or individuals paying the alternative minimum tax ("AMT") gain any benefit. Recent legislative changes enable non-publicly traded companies averaging \$50 million or less in gross receipts in the prior three tax years to use the credit to offset the AMT.

### And What about Developing Internal-Use Software?

Recently- issued final Treasury Department regulations addressing software developed for a taxpayer's internal use are also taxpayer friendly. Generally, internal-use software does not qualify for the research credit. However, the most recent regulations narrow the definition of internal-use software to software that is developed for general and administrative functions. This specifically encompasses financial management, human resource management and support services functions.

Therefore, software that is not developed to be used for general and administrative functions is not internal-use software (or at least is dual use); this is true even if the software is not developed to be licensed to third parties and is not developed to enable the taxpayer to interact with third parties.

### **Follow up on Your Opportunity**

These positive changes continue the trend of favorable developments for taxpayers regarding the research credit in recent years. In light of these changes, qualified small and middle market companies or any that conduct research should review their expenditures and determine whether to pursue the research credit. One caveat: properly documenting which activities and expenditures qualify under the IRS 4-part test can be daunting. Therefore, taxpayers seeking to claim the credit should consult a tax professional.

### **Contact Us**

If you have questions regarding claiming, supporting or defending the Federal Research Tax Credit or the respective state research credits, contact Sandy Weinberg at [sweinberg@pkfod.com](mailto:sweinberg@pkfod.com) or Jill Cantor at [jcantor@pkfod.com](mailto:jcantor@pkfod.com).

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