

Tax Notes

Are We Still in the Golden Age of the Research Tax Credit?

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Claiming the Federal Research and Development Tax Credit (Research Credit) has never been more beneficial. As a result, in recent years, many small, middle-market and start-up companies have begun capturing the credit. Construction, architectural design, engineering, financial services and manufacturing companies, as well as those developing pharmaceutical products, software, and chemical products, have taken advantage of the credit.

For tax years beginning in 2022, the benefits may lessen. The Tax Cuts and Job Act (TCJA) is the culprit. But there is hope.

First, the Good News

It should be noted that the TCJA expanded the Research Credit opportunity. Effective beginning in 2018, the TCJA, by reducing the federal corporate tax rate from 35% to 21%, also indirectly increased the value of the credit for both corporate and non-corporate taxpayers. The increased benefit occurs when taxpayers elect the reduced credit under IRC Section 280C(c)(3). For most taxpayers, electing the reduced credit is recommended. Before the TCJA, taxpayers electing the reduced credit reduced their Research Credit by 35%, and thereby only recognized a Research Credit benefit of 65% of the pre-election credit. Under the TCJA, taxpayers reduce the pre-election Research Credit by only 21%, thus now recognizing a benefit that instead equates to 79% of the pre-election credit. In essence, since the TCJA went into effect, the benefit of the Research Credit increased by more than 20%.

For the Research Credit, the TCJA's Downside Begins in 2022

That, however, is the good news regarding the TCJA and the Research Credit. The bad news is that the TCJA contains an IRC Section 174 deduction limitation that is effective after 2021. Currently, IRC Section 174 provides taxpayers with the option, which most taxpayers choose, of immediately expensing research expenses.

Beginning in 2022, the TCJA eliminates the current year deduction option, and requires taxpayers to instead capitalize the research expenses and amortize them over 5 tax years, beginning with the midpoint of the tax year in which the specified research expenditures are paid or incurred. As a result, companies capturing the Research Credit after 2021 will only be able to use one-fifth of the current year's qualifying research expenses to capture the credit in that year.

Will the More Beneficial Research Credit Be Protected?

All is not lost on this front. President-Elect Joe Biden has, in general, called for tax proposals intended to boost research and stimulate the economy. There has been speculation that he will endorse expanding the Research Credit. He may first push for the repeal of Section 174's upcoming 5-year amortization requirement, thus leaving the immediate expensing option available for research expenditures in place. He may also increase the alternative simplified credit (ASC) rate. The ASC is an alternative easier method of calculating the Research Credit.

What Should Be Done Now?

Taxpayers can still take advantage of claiming the more beneficial research credit in 2020 and 2021, as well as prior open years. Recent taxpayer-friendly developments, among others, have included favorable

internal use software regulations, and the ability for start-ups to take the credit against payroll taxes. [Documenting](#) the Research Credit remains key.

Companies with research expenditures should:

- Speak to a Research Credit specialist. A short conversation could lead you in the right direction.
- If you are eligible for the credit, estimate the potential benefits of capturing the credit for all years that are open.
- If the benefit is significant, and the cost and time commitment worthwhile, work with your Research Credit specialist to conduct a research credit study to capture all of the eligible qualifying expenses, ensure that the research projects qualify, and compile all proper documentation including project narratives and contemporaneous written information.

Contact Us

If you have any questions or need assistance regarding research credits, or wish to have a Research Credit study performed, contact your client partner or the following:

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