

Federal Research Tax Credits for Startups

Guest Post By Dan Wright

Federal Research Tax Credits

Is your business involved in creating intellectual property or process and product improvement? If so, you or your business may qualify for federal research tax credits.

Common Misconceptions

First, let's clear up some myths about what business activity qualifies for the credit. Many people think of white coats and test tubes when they hear the word "research." However, in this context, the definition is much broader than that.

Another common misconception is that the research, or resulting products, must be completely original to qualify. However, that is not generally the case. Instead, qualifying research very often involves research that results in a product or process that is only new to the business performing the research. That fact that similar products or research may already exist is not relevant to qualifying your business activity.

What is the Credit Based On?

The credit is a wage-based program, which you can calculate by identifying the wages paid to employees who perform qualified research activities. Amounts paid to outside consultants are also included in the credit at 65% of each qualifying dollar spent. In some cases, supplies that are consumed in the research process can also be included in the calculation.

Multiple methods of calculating the credit may be available. But in short, the credit available to the qualifying business activity equates to 6%-20% percent of the incremental research expenses. The exact percentage is determined by the elected applicable method.

Who Qualifies for the Credit?

Any business performing qualifying research can qualify for the benefit. Since the incentive is in the form of a tax "credit," the business must have a tax liability to get a current cash benefit. It is not a refundable credit, but the portion of a credit that is not used in the year it is generated can be carried forward.

Since regular corporations are subject to federal tax, they can claim the credit. Businesses that are considered "pass-through" entities for federal income tax purposes, such as LLCs that have

elected partnership status and corporations (or LLCs) that have elected S corporation status, pass the credit through to the owners of the entity.

What Qualifies as Research Activity?

Only business activity conducted in the U.S. qualifies. Further, the research activity must be “technological in nature.” This means that it must involve a hard science, such as computer software; engineering; medical, biological, or physical research; or other similar science disciplines.

Additionally, “funded research” does not typically qualify. This means that if research activity is funded by an outside source, such as grants or customers, the arrangement must be carefully evaluated to determine if it qualifies. That said, the fact that the research is partially or wholly funded by third parties does not automatically disqualify the activity.

What Activities do not Qualify?

The rules specify which business activities are disqualified. These activities include:

- Costs incurred once production of the component begins;
- Adaptation of an existing component to a particular customer's requirement or need;
- Efficiency surveys;
- Activity related to management function/technique;
- Marketing research;
- Advertising or promotions;
- Routine data collection/testing to evaluate quality control;
- Activity related to style, taste, cosmetic or seasonal design factors.

New Opportunities that Apply to 2016 and Beyond

Alternative Minimum Tax (“AMT”) Offset

Until 2016, the credit could only be used to reduce a regular tax liability. Beginning in 2016, however, it can also be used to offset AMT liabilities. The AMT offset is only available to businesses with under \$50 million in gross receipts. However, credits passing through from qualifying businesses can still apply to individual tax liabilities.

Payroll Tax Election

Beginning in 2016, qualified startup businesses can generate research credits. Qualified startup businesses include those that have not had “gross receipts” for more than 5 years (meaning, the five year test starts with the first year in which business had gross receipts), and have had gross receipts of less than \$5 million in the claim year. Research credits can then be used to offset the

employer's portion of the FICA tax in the following year. It's worth noting, however, that startups should consider the related party rules when applying the gross receipts tests.

Since many startup businesses don't generate taxable income in the early years after formation, the credit program historically provided little, if any, immediate benefit. Now that the credit can be used to offset payroll taxes, the credit has real value for qualifying startups.

Questions?

If you would like help determining if your business activity qualifies for the research credit incentives, and/or determining an estimate of the benefit, please contact Dan Wright at dwright@clarknuber.com.