What the PATH Act Means for R&D Credits and Why You Should Care

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Since being enacted as part of the Economic Recovery Tax Act of 1981, the federal research and development (R&D) tax credit has never been made permanent. It was always a tax extender that lapsed and was reinstated by Congress and, typically, at the last possible minute. In fact, since inception, the credit has been extended more than a dozen times. Consequently, business owners could not rely on it from one year to the next and, therefore, never used it as a planning tool to reduce their taxes.

With the passage of the Protecting Americans from Tax Hikes (PATH) Act of 2015 in December, the federal R&D tax credit is now reinstated back to Jan. 1 2015 and is a permanent tax break for companies performing qualifying research as of Jan. 1, 2016. It is estimated that this provision of the PATH Act will cost the government about $113 billion in annual revenue over the next 10 years. This substantial amount of money can be used by small businesses in a variety of ways, including offsets against the Alternative Minimum Tax (AMT). More on this later.

How Does The Research Credit Work?

Basically, the federal research credit is determined as a portion of every qualifying dollar spent on R&D activities in the areas of qualifying wages, supplies and outside contractor/consulting fees. In some cases the credit is 20%, and in others it is 14% or 6%. The credit percentage varies based on what method of calculation is used and is also a function of past R&D activities. The more you incur in qualified costs, the more your research credit will potentially be. There is no limit to the credit amount a company can generate. These federal research credits can then reduce federal income taxes.

Prior to the enacting of this law (with the exception of small businesses in the 2010 tax year), R&D credits could only be used to reduce regular federal taxes. A company could generate thousands of dollars in federal research credits, but not be able to use the credit if it was paying federal AMT. This became a bane for many taxpayers who tried to take advantage of this credit.

As part of the PATH Act, small businesses (defined as non-public companies with less than $50 million in average annual gross receipts for the previous three years) can permanently use research credits generated after Jan. 1, 2016 against both regular tax and AMT. This makes the research credit much more valuable. In some instances, companies with less than $5 million in gross receipts can elect to use the research credits generated after Jan. 1, 2016 to offset payroll taxes. This should be a windfall for startup companies that have no income tax liability.

To illustrate these rules, a middle market manufacturing company that I work with will benefit greatly from this new legislation. This company is not considered a small business for purposes of using the R&D credit to offset payroll taxes; however, they will benefit from the use of the R&D credits to offset AMT. This company is an S-corporation with two 50 percent owners. The R&D

credits generated will flow through to them on the K-1 from the S-corporation. Unfortunately, for many years the two owners have not been able to use the federal R&D credits because they were in AMT. However, beginning in 2016 they will be able to generate federal R&D credits and use them on their individual returns to reduce their AMT. This should save the two owners a substantial amount of tax for 2016 and in the future due to the permanency of the federal research credit.

Congress intended to cast a wide net to reward companies for R&D and stimulate economic growth. Research credits can be found in the aerospace, technology, medical device, manufacturing, food, software development, biochemical and agriculture industries, to name a few. This is where a competent CPA is extremely valuable. He or she should be able to assess their clients' activities and determine eligibility for the credit.

The credit is available for companies that design, develop or enhance new products and/ or processes. This includes the manufacturing process and the development of computer software. Technical uncertainty must be present at the beginning of the project in either capability, method or design of the product, software or process. Furthermore, the company must engage in a process of experimentation (similar to hypothesis testing) to eliminate that uncertainty and either prove that the design succeeds or fails. This is what companies are doing every day to remain competitive in their market. Companies may not have identified these as qualified R&D activities, but they are. At its core, the research credit was enacted to reward companies for taking risks and solving technical problems in developing new or enhanced products, software or processes.

OK, So What Do I Do Next?

CPAs will have to work closely with their clients to assess the applicability of this credit and determine the amount of the credits that are available. Clients will also need to invest the time and energy of company personnel to identify and assemble the supporting documentation. This is a very complicated credit that requires a deep expertise to navigate the many tax changes that have taken place over the years in this area.

Once the credit availability is identified, CPAs can help their clients implement policies and procedures to capture qualifying activities and reap the benefits of a lower overall tax bill. The benefits of a reduced tax bill will typically far outweigh the soft cost and consulting fees that will be incurred during this process.

Now is the time to get this done at the start of 2016. Don't delay; a lower tax bill is waiting.

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