Long Island Business News
http://libn.com/2016/11/21/feds-expand-rd-tax-credit/

KAREN O'CONNOR: To qualify for the credit, companies need to document that their uses are eligible.

Feds expand R&D tax credit

By: Claude Solnik November 21, 2016 0

The federal research and development credit has long been elusive for the very firms it's supposed to help, a kind of apple tantalizingly out of reach.

Tech startups frequently have no income, so they pay no income taxes and can't use a credit.

But Congress has devised a way to let startups tap that credit, by taking it off of their payroll taxes, as part of a new menu of ways to utilize R&D tax benefits.

"Can you imagine that?" Stuart Shapiro, a partner at Shalik, Morris & Co. in Woodbury, said. "Imagine being able to use the credit against $250,000 per year in payroll taxes as a startup?"

Firms must qualify as startups to use the credit against payroll taxes, although they don't have to be in traditional tech industries.

Karen O'Connor, director of corporate tax services at Marcum, with Long Island operations based in Melville, said this is designed to make the credit useful to the firms that need it the most.

“The intention was to get cash into the hands of people trying to find new processes and products,” she said, noting it so far typically took five years before startups had earnings toward which they could use the credit. “They said, ‘Why don’t we add a rule?’”

As of 2017, startups with annual gross receipts of less than $5 million and no gross receipts beyond the past five years will be able to apply R&D tax credits toward up to $250,000 in payroll taxes.

Even firms that aren’t making money can carry their R&D tax credits back one year and use them 20 years forward.

“People call this credit a second bite at the apple,” O’Connor said, referring to the fact that expenses qualifying for the credit can be used to reduce taxable income in addition to being used to compute the credit.

If a company has up to $50 million gross sales, it can use the benefit against the alternative minimum tax.

There are many obstacles to getting the credit, although the biggest may not be qualifying, but being aware that you are eligible.

“If you went to 100 accountants, about 30 might be using it,” Shapiro said. “They don’t realize it can be utilized in many businesses besides the typical R&D type.”

To qualify, firms must meet a four-part test, showing the uses are technological in nature, involve technical uncertainty, fit permitted purposes and involve some form of experimentation.

“It must apply to hard sciences,” O’Connor added. “Math, bio, chemistry, physics, computer sciences. It’s not meant for the arts and humanities. There needs to be some technical uncertainty.”

But that doesn’t mean R&D is limited to firms doing traditional scientific research. As computers become part of the process for many things, businesses far beyond the lab often qualify.

“You’re intending to develop a new or improved product or process,” O’Connor said. “You can do it by manufacturing, testing new technology trying to develop more reliable products and processes, experimentation.”

Manufacturers often qualify, as well as engineering and architecture firms, chemical companies, breweries, software, electronics, biotech, pharmaceutical, professional service, lumber and other firms.

“Internally developed software counts,” O’Connor said. “A lot of people are developing or implementing software for their own needs.”

A textile company, for instance, might sound far from your typical tech firm. But one such company that makes a wide range of apparel found it qualified for a $300,000 R&D tax credit.

The firm’s staff used computer-assisted design to develop products, such as sports bras, where there was some question as to whether they would go to market, Shapiro said.

“They’re designing a product where there’s some element of doubt,” Shapiro said. “The whole key is that the tax laws are much less restrictive in who and what could qualify for the credit.”

He pointed to an audio-visual system integrator that also qualifies for the credit, since its operations fit the definition.

“They design systems,” Shapiro said. “If you have technicians, designers, that’s where the credit comes from.”

While one might expect the proof to be in the product, that isn’t always the case. Even or especially if something doesn’t make it to market, the firm may qualify for the credit.

“All the activities you are doing need to be on U.S. soil,” Shapiro said. “You have to work through the technical uncertainties, but you don’t need to succeed.”

Eligible costs typically include salaries, payments to independent contractors and consultants and supplies, but firms need to show the expenses.

“You have to keep contemporaneous documentation as you go through this,” O’Connor said. “You don’t want to wait to claim this credit.”

To support claims, companies may want to show testing logs, lab notebooks, error logs and other documents. “You’ll be able to point to certain individuals, what they did and how long,” O’Connor added.

Although accountants may help companies qualify, consulting firms such as the Alliant Group also specialize in that.

“They do all the paperwork and give the accountant everything he needs to claim the credit,” Shapiro said, noting those firms can be key in obtaining credits.