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Tax Credits and Incentives to Benefit Growing Businesses Part 1

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Credits and Incentives can be very beneficial to companies in all industries, yet credits continue to go unclaimed. Companies without the capacity to perform the necessary compliance and diligence to obtain the incentives explain part of this, but the more prevalent reason is probably sheer ignorance. Companies are unaware of the potential benefits available to them.

It is true that credits and incentives vary from year to year, and jurisdiction to jurisdiction. Unless a company is on top of the latest political agenda, it's difficult to know if a particular incentive was recently enacted or has sunset. Tracking and pursuing credits takes effort, and companies often do not have the resources to track them. That said, it is in a company's best interest to make this a priority. Credits and incentives could be a valuable element in any company's tax planning strategy, and failing to consider these potential assets could create a competitive disadvantage.

This article will shed some light on a few credits and incentives currently available to companies, including why credits exists in the first place, types of credits, and activities businesses should look out for in order to identity opportunities that may qualify.

Part I of this article will provide an overview of some common types of credits and the optional industries and activities to which they apply. We will also provide some details of the federal and state research and development tax credit. Part II will provide detail on some of the common New York State credits and incentives.

I. Why Credits and Incentives?
Governments are constantly looking to attract business and grow their local economies. Business growth and job creation generally leads to more revenue that jurisdictions can then use to balance their budgets and meet fiscal objectives. By offering incentives, governments hope to entice businesses to locate and expand in their locations. It's the "give a little, get a lot" mentality.

Some incentives are created for a specific cause. For example—during COVID, many states offered various incentives to stimulate their economies.

The overall objective of the government body in offering incentives is the return on investment in these businesses and their owners. Companies should perform due diligence to learn about the various incentives available and the necessary steps to take advantage of them.

Types of Incentives
The types of credit and incentive programs available target specific industries, job creation, capital investment and economic development, specific locations or zones, certain social activities, and

environmental objectives. Credits and incentives could be statutory or as of right credits, discretionary or as negotiated incentives, or a hybrid approach.

A. Statutory ("As of Right") credits are generally based on a specific set of requirements outlined in the statute and regulations. An application may be required (hybrid incentive) in order to confirm the business qualifies, but generally a business just needs to satisfy the described requirements, at which point it can claim the credit/s on an original (or in some cases, amended) tax return. The credit is subject to an audit by the taxing jurisdiction to confirm the business satisfied its requirement. Statutory credits and incentives are generally in the form of:

- Refundable of nonrefundable tax credits
- Exemptions

  Some well-known statutory incentives include:

- The New York Qualified Emerging Technology Tax Credit (QETC)
- The New York Investment Tax Credits (ITCs)
- Federal and state Research and Development (R&D) tax credits
- Work Opportunity Tax Credit (WOTC)
- Industry-related credits (e.g., film and television production credits, manufacturing credits)

B. Discretionary ("As Negotiated") incentives, on the other hand, are generally negotiated with economic development or other governmental officials in advance. Businesses usually have to make the argument that the specific incentive is a significant consideration in the potential project ("but for" argument) and the project may not happen if the incentive is not obtained. In addition, consideration is given to factors such as the size of the capital investment made by the company, the location of the project, the type of industry of the business, the number of jobs created or retained, and the amount of wages paid to the employees.
States will also look at whether the business is realistically considering another location outside the state and estimate the potential return to the jurisdiction in terms of employment, growth and/or tax revenue overall.

These incentives generally include an application process and commitments (e.g., hiring/retaining jobs, capital investment over a stated period) as part of the negotiations with jurisdictions. Ongoing compliance and accounting is usually necessary to support the company's commitment to earn the incentive or avoid clawbacks of provided incentives.

Discretionary credits and incentives are generally in the form of:

- Cash grants/low cost financing
- Payroll tax credits
- Refundable tax credits
- Property tax abatements
- Sales tax exemptions/abatements
- Utility reductions

Some well-known discretionary incentives include:

- The New York Excelsior Program (rewards businesses in certain industries that commit to create a specified number of new jobs, expand, or perform research and development in New York)
- The New Jersey Emerge Program (rewards businesses in certain industries operating in certain areas, that commit to create or retain a specified number of new jobs, make capital investments, and/or perform research and development in New Jersey)
- The California Competes Tax Credit (available to businesses that locate, expand or keep well-paying jobs in California)

Industry and Activity Focus
Certain credits (e.g., manufacturing investment credits, software development hiring credits) are industry-focused. Other credits (e.g., research and development credits, workers' opportunities credits) tend to be more activity-focused. Realistically, there tends to be correlation between the activities and the industry. For example, a manufacturer or software developer may not be hiring as many employees as companies in other industries, but they are hiring skilled workers at higher wages and thus are making a significant capital investment. Healthcare facilities or transportation companies, on the other hand, probably have a much greater turnover within targeted employee groups, and hiring credits may be a good fit for them.

The following industries have targeted incentives to promote business activity and higher wages:

- Technology
- Manufacturing
- Film/Entertainment
- Life Science
- Aerospace / Defense
- Agriculture
- Financial

Specific Credits

Jobs Credits
Generally, jobs credits reward companies for hiring and retaining employees. The credit can be computed as a percentage of qualifying wages or increased employment over a base period. The credit can be used to promote certain social policies. For example, the federal WOTC provides a nonrefundable tax credit designed to incentivize hiring individuals with barriers to employment (e.g., convicted felons, disabled people, veterans, long-term unemployment recipients, people who receive temporary public assistance, etc.). Businesses need to apply for the WOTC credit upfront through a screening process that is submitted to the State's Department of Labor (DOL). If approved, the credit maxes out at about $2,400 for each new hire in most target groups, but could be as much as $9,600 for specific groups.

Many states provide credits similar to WOTC incentives for hiring employees with barriers to entry. States generally require that the employees be located from within that jurisdiction. The New York State Workers (with Disabilities) Employment Tax Credit (WETC), New York Youth Jobs Program,

and New York State Recovery Tax Credit are some examples of such hiring credits. States also provide hiring incentives for general expansion and growth. Credits such as the New York Excelsior Jobs Program tax credit place less emphasis on the employee's barrier and instead focuses on expansion, relocation, and the overall increase in employment for businesses in certain industries.

Investment Credits
States or other jurisdictions offer an ITC for business that invest in qualifying property, equipment or machinery in the state. The purpose is to promote capital investment in the state or jurisdiction within a particular industry or for a specific purpose.

R&D Tax Credits
The federal R&D tax credit rewards companies that are conducting research and development in the United States. The R&D credit provides over $10 billion of tax savings to U.S. businesses annually. The National Science Foundation data indicates another $4 billion in unclaimed R&D credits.[1] In addition to the federal credit, many states have their own R&D tax credit. Companies may take a credit federally and locally for the same activity making it even more beneficial to businesses and their owners. Some states, such as New York, have R&D as a component for claiming certain credits and incentives.

Federal and State Research and Development Credit
The Economic Recovery Tax Act of 1981 (ERTA) originally introduced the R&D tax credit, also known as the research and experimentation (R&E) tax credit, as a two-year incentive. This initial temporary incentive has remained part of the tax code ever since, which has benefited thousands of companies in diverse industries.

The credit is often underutilized, particularly by small and medium-sized companies due to misconceptions by taxpayers and tax professionals.

For example:

- The R&D tax credit would not help the taxpayer because the company is not profitable.
- The R&D tax credit is only for big companies.
- The R&D tax credit is not important since the taxpayer already gets a deduction.

In order to clear up common misconceptions, it is important to note that smart tax planning does not begin in the year tax liability occurs but years before. Tax planning should include taking advantage of all available benefits to the taxpayer. A taxpayer does not need to have a tax liability to take advantage of the credit. The credit carries forward 20 years and back one year,[2] thus providing a benefit even when a taxpayer is in a net loss position. In addition, some start-up companies may be eligible to claim a credit against payroll tax, regardless of income liability. Some states also offer refundable R&D tax credits. Many taxpayers would prefer taking advantage of these credits in the year the credit is generated and avoid the audit risk of amending returns. By passing up the opportunity to take advantage of the credit, even in a "loss year," taxpayers could be putting a significant future benefit in jeopardy.

Big companies may claim larger credits due to their activities, but the program is open to any size entity. The credit is based on qualified activities, not entity size. The credit, however, must be actively claimed annually; it is not automatically granted.

The credit is in addition to any tax deduction and represents a dollar-for-dollar reduction in income tax liability.

By speaking with the right R&D tax advisors, taxpayers are better informed and not tripped up on common misconceptions.

Industries where R&D qualified expenses often occur include, but not limited to:

- Manufacturing & Distribution
- Software & Technology
- Construction
- Food & Beverage
- Consumer Products
- Cannabis
- Healthcare

General Calculation

The R&D credit is calculated by determining the amount of qualified research expenses (QREs) for the company's current and prior three years. QREs are made up of wages, supplies used in the R&D development, and 65% of third-party contractor researchers.[3]

In order to meet the definition of qualifying research expenditures, research activities are required to be performed in the United States and need to satisfy the IRS's "Four Part Test":[4]

1. The work is being performed to develop a new or improved **business component** (product, process, technique, formula, invention or computer software component).

2. The activities are performed to discover information that is **technological in nature**. The activities involve physical, biological, engineering or computer sciences.

3. The research is performed to eliminate **technical uncertainty**, determine if a desired result could be achieved, how to achieve it or determine the specific design of a product.

4. The activities include a **process of experimentation** involving identification of the technical uncertainties, alternatives to consider in eliminating the uncertainties and a process for evaluating alternatives.

The R&D tax credit can provide significant benefits to taxpayers with qualifying activities. Changes in law from 2015 Protecting Americans from Tax Hikes (PATH) Act and the 2017 Tax Cuts and Jobs Act (TCJA) have made the R&D credit more lucrative by providing taxpayers potentially larger credits.

PATH Act

A. Payroll Tax Relief

The PATH Act of 2015 allowed the R&D income tax credit to be applied against the employer OASDI (Social Security) portion of payroll taxes for "qualified small businesses." A qualified small business is defined as one with less than $5 million of gross receipts for the tax year, and no gross receipts for any tax year proceeding the five–tax-year period ending with the current tax year.

The payroll credit is limited to $250,000 per year for up to five years, and any unused portion can be carried forward to future years. The tax credit may also be claimed if the business uses a Certified Professional Employer Organization (PEO).

This provision thus allows qualified small business the ability to utilize the R&D tax credit against payroll taxes, where it might have not previously had the opportunity to utilize the credit due to the company not having taxable income.

B. Alternative Minimum Tax Relief
Another benefit added as part of the PATH Act of 2015, was the ability for partnerships, sole proprietorships or taxpayers that are not publicly traded corporations, with average annual gross receipts not exceeding $50 million for the three taxable years preceding the current taxable year, to utilize the credit to offset AMT (Alternative Minimum Tax).

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A. Increased Credit Value

Internal Revenue Code (IRC) § 280C requires any taxpayer who claims the R&D tax credit to reduce its research expense deduction by an amount equal to the R&D tax credit claimed. Alternatively, taxpayers can elect to take a reduced credit in lieu of reducing research expense deductions. The R&D tax credit is reduced by the maximum corporate tax rate.[4] The election must be made on a timely filed original return (with extension).
Due to the corporate tax rate reduction from 35% to 21%, the TCJA effectively increased all R&D tax credit benefits after 2017 by approximately 21.5%. For example, a taxpayer whose research credit equals $10,000 makes the election to reduce the credit by the maximum corporate tax rate in lieu of reducing research deductions. Prior to TCJA, taxpayer's credit would be $6,500 ($10,000 *65%). After TCJA, the taxpayer's credit is $7,900 ($10,000 *79%), resulting in an increased value of $1,400 (or 21.5%).

B. Alternative Minimum Tax Impact
Historically, corporations could only use the R&D tax credit to offset federal income tax liabilities and not AMT liabilities; eligible small businesses are already exempt from this provision under the PATH Act. The TCJA repealed the corporate alternative minimum tax (AMT) and increased the exemption and phase-out amounts for individual AMT. Corporations may now reduce their liability without an AMT limitation.

However, corporate taxpayers are still subject to a minimum tax requirement specifying that a credit cannot offset more than 75% of a taxpayer's regular tax liability above $25,000.

State Research and Development Credit
Most states provide a research and development credit. States generally calculate the credit either as a percentage of the increase in research and development expenditures, or as a statutory percentage of the dollar amount of the federal credit. However, states will only provide a credit for the research and development investments incurred within the taxing jurisdiction. The state definition of qualified research may also vary slightly from the federal definition in order to advance the interests of certain industries. Most state definitions are similar to the federal definition and allow a carryforward of the credit.

Conclusion
Credits and incentives are very powerful tools used by governments to trigger specific economic outcomes. Companies that are involved or seeking to become involved in certain activities could benefit from these incentives. Using these tools effectively increases overall cash flow. Companies should consider consulting tax credit and incentives professionals to assist with obtaining and

negotiating these benefits. There are hundreds of incentives nationally that businesses and owners can consider. Some of these incentives are localized to specific counties or tracts. Therefore, careful planning and scoping should be done prior to any planned expansions, development, hiring or capital investment to ensure proper realization.

Stay tuned to our next segment, Part II of this article, where we will describe in more detail some of the common New York credits and incentives, along with their nuances and considerations that could help businesses.

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1 National Science Foundation, National Center for Science and Engineering Statistics; U.S. R&D Resumes Growth in 2011 and 2012, Ahead of the Pace of the Gross Domestic Product, Arlington, VA (NSF 14-307, December 2013).
2 IRC §38
3 IRC §41(b).
4 IRC §280C(c)(2)