R&D Tax Credit Enhanced by Virginia and Federal Legislation

Virginia legislative enhancements provided by the 2016 Virginia General Assembly session to the state research and development tax credits, coupled with expansions of the federal credit provided by the PATH Act (Protecting Americans from Tax Hikes Act of 2015) in late 2015 give Virginia taxpayers extra incentive to pursue Research and Development Tax Credits.

Many companies are unaware that their day-to-day operations could qualify them for a both a federal and state tax credit. Companies that attempt to create products that are lighter, faster and less expensive can qualify for the R&D tax credit; as well as those creating more durable, reliable, or precise products. R&D tax credit eligibility is also much broader than many companies realize. Credits apply to not only the development of products, but also activities and operations; such as new manufacturing processes, software development and quality enhancements. The R&D tax credit has continued to draw support from federal and state politicians on both sides of the aisle.

Federal Enhancements from the PATH Act (December, 2015)
Offset Payroll Taxes. Beginning in 2016, qualified small businesses (start-up companies with gross receipts of $5M or less) may take advantage of the R&D tax credit to offset payroll taxes of up to $250,000 per year. Prior to this change, companies who paid no income tax, including many innovative start-up companies that were investing heavily in R&D activities, could not benefit from the non-refundable R&D tax credit. This change is a significant benefit for many small businesses that need an extra "shot in the arm" to help fund their research and development investments.

Offset Alternative Minimum Tax for Eligible Businesses. Also beginning in 2016, eligible small businesses (those with less than $50M in average annual gross receipts) may utilize the R&D tax credit to offset their Alternative Minimum Tax (AMT). Previously the R&D tax credit did not offset AMT, limiting the benefit of the credit for many innovative businesses. Those entities that operated as a "pass through" for tax purposes and where the individual owners were subject to Alternative Minimum Tax were particularly affected. Sole proprietorships, partnerships, LLCs and S corporations are pass-through entities for federal income tax purposes. These entities are not subject to income tax, rather, the owners are directly taxed individually on the income. According to the National Association of Manufacturers, two-thirds of manufacturers are organized as pass-through entities. Again, this change will provide the needed incentive to help many of America's businesses fund research and development efforts and grow their companies.

Virginia Enhancements from Senate Bill 58 (signed March 2016 and effective for tax years starting in 2016).
More money, more years. Virginia extended the "sunset date" of the R&D tax credit program from January 1, 2019 to January 1, 2022. Also, the total annual funding cap for the program was increased from $6 million to $7 million per year.

Higher Maximum Credit. The maximum amount of Virginia R&D tax credits each taxpayer may claim each year was increased from $35,100 to $45,000 (from $45,000 to $60,000 if the R&D is conducted in conjunction with a Virginia college or university.)

Simplified credit. Further, Virginia now allows companies to qualify for credits under a method that is similar to the Federal “alternative simplified method.” Under the alternative computation, the companies are allowed a refundable credit equal to 10 percent of the Virginia qualified research expenses (QREs) for the taxable year that exceeds 50 percent of the average Virginia QREs paid or incurred by the taxpayer for the three taxable years immediately preceding the tax year of the credit claim. For taxpayers that did not incur Virginia QREs in any of the three prior years, the tax credit under the alternative computation is five percent of the Virginia QREs paid or incurred in the taxable year.

Large Companies Qualify for More. Virginia also created a new tax credit beginning with taxable year 2016 for businesses with Virginia research and development expenses in excess of $5 million for the taxable year. The new tax credit will include the same elements as described above for the alternative computation, except that it is not refundable and there is no annual limit on the maximum amount of credits allowed for the taxpayer. In addition, the Virginia Department of Taxation may grant up to $20 million in tax credits each fiscal year beginning with fiscal year 2017. The amount of the new tax credit that may be claimed by the taxpayer for each year will be limited to 75 percent of the taxpayer's Virginia income tax liability for the year. Any unused credit for the year may be carried forward and applied against the taxpayer's income taxes in the succeeding 10 taxable years. The new research and development expenses tax credit expires January 1, 2022.

Virginia prohibits taxpayers from claiming the R&D tax credit for expenses incurred using embryonic stem cells. Also, the 2016 legislation prohibits a taxpayer from claiming both the existing and new research and development expenses tax credit for the same taxable year.

The applicability of the R&D Tax Credit should be considered for every business taxpayer. If you would like additional information on R&D Tax Credits, please contact your DHG tax advisor or Nick Harrison **|** 804.474.1266 **|** nick.harrison@dhgllp.com.