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ARTICLES

Although the PATH Act doesn't include the numerous proposals to change how the RTC is calculated or increase its credit rate, it does expand its availability to two kinds of small businesses.

Jan. 20, 2016



2015 was a great year for the federal Research Tax Credit (RTC): in January 2015, proposed regulations significantly broadened the range of software-development expenditures eligible for the RTC; and in December 2015 the *Protecting Americans from Tax Hikes Act of 2015* (PATH Act) permanently extended it.

By putting an end to the credit's 34-year roller-coaster history of expiring and being extended (often only retroactively), the PATH Act enables businesses to factor the

RTC into their regular tax planning and investment decisions. In addition, the PATH

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First, “eligible small businesses” may now claim the credit against their Alternative Minimum Tax (AMT). Under prior law, companies generally were able to use the credit to offset only regular income tax liability. This meant small companies and pass-through entities subject to AMT often couldn't benefit currently from the RTC. Although this provision applies to tax years beginning after December 31, 2015, such companies may be able to use their 2016 credit against their 2015 tax liability if they can carry it back one year, as Internal Revenue Code (IRC) section 39 allows for other General Business Credits.

Second, “qualified small businesses” may now elect to take up to \$250,000 in RTCs against the employer portion of their payroll or FICA taxes. This election, which can be made for up to five taxable years, provides start-ups a significant and immediate benefit, enabling them to recoup some of their investment to develop new or improved technologies, even if they aren't currently paying regular income taxes.

“Eligible” and “Qualified” Small Businesses

“Eligible” small businesses are different from “qualified” small businesses.

Eligible small businesses include closely held corporations, partnerships, and sole proprietorships whose annual gross receipts for the three preceding tax years average no more than \$50 million.

Qualified small businesses are corporations, partnerships, or persons (1) not exempt from income tax under IRC section 501; (2) with gross receipts in the taxable year of less than \$5 million; and (3) with no gross receipts prior to the five taxable years ending in the taxable year. For purposes of this provision, all members of the same controlled group or group under common control are treated as a single taxpayer, and the \$250,000 amount must be allocated among the members in proportion to each member's expenses on which the research credit is based.

Other New Opportunities: RTC's Wider Availability

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Generally, the RTC is provided for activities that meet each of these tests.

1. Attempts to develop or improve the functionality, performance, reliability, or quality of a taxpayer's product, process, software, invention, technique, or formula (business component);
2. Encounters uncertainty regarding either the taxpayer's capability or methodology to develop or improve the business component, or its appropriate design;
3. Includes a process of evaluating alternatives to eliminate the uncertainty; and
4. Fundamentally relies on technological principles, i.e., those of engineering or the computer, physical, or biological sciences.

You may be trying to develop something your competitors have already developed. Aside from reverse engineering activities, your efforts to try to do what they've already done may qualify. This is true even if you fail. Except in the case of activities to develop **internal-use software** (IUS), the level of technological advancement sought is not relevant to whether activities qualify. And even though IUS development activities are subject to higher standards to qualify, 2015 greatly expanded the extent to which software development in general qualifies.

Generally, activities to develop IUS aren't eligible for the credit. Before the Treasury's 2015 proposed regulations, "IUS" was defined broadly, resulting in a significant portion of software development expenditures being excluded from the credit. This was true even though in many cases the "internal-use" software wasn't by design or in fact being used internally by the taxpayer's employees; it was being used by online customers. The 2015 regulations, affecting taxable years ending after January 20, 2015, narrowed the definition of "IUS" to software developed by or for the benefit of the taxpayer for general and administrative back-office functions, namely financial management functions, human resource management functions, and support services functions. Software that is consumer-facing and benefits third parties will not be treated as IUS.

By narrowing the definition of “IUS,” the regulations narrowed the IUS exception,

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these concerns shouldn’t stop companies from taking a more strategic and timely approach in 2016 to reviewing their eligibility and maximizing their savings.

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