

Federal Tax Credits

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Practitioners' Tax Forum

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Agenda

- ❖ Overview
- ❖ Limitation on Business Tax Credits
- ❖ Specific Business Tax Credits
- ❖ Open Forum

Overview

- ❖ Tax credits are:
 - Business credits intended to provide special incentives for achievement of certain business objectives or
 - Personal credits designed to provide tax benefits to certain taxpayers (e.g., the elderly or disabled)
 - Some credits apply to both business and nonbusiness taxpayer

Types

- ❖ Three main categories
 - ▶ Business Incentive Credits
 - ▶ Personal Credits
 - ▶ Foreign Tax Credit
- ❖ Credit for alternative minimum tax
- ❖ Tax credits attributable to certain “passive activities”

Limitation on Business Credits

- ❖ A credit is allowed against income tax for a particular tax year equal to the sum of:
 - ▶ (1) the business credit carryforwards carried to the tax year,
 - ▶ (2) the current year business credit, and
 - ▶ (3) the business credit carrybacks carried to the tax year.

Limitation on Business Credits

- ❖ The credit allowed for any tax year (except for the empowerment zone employment credit, the New York Liberty Zone business employee credit, and “specified credits”) is limited to the excess of taxpayer's “net income tax” over the greater of:
 - (1) the tentative minimum tax for the tax year, or
 - (2) 25% of the amount of the taxpayer's “net regular tax” that exceeds \$25,000.

Limitation on Business Credits

- ❖ Husbands and wives who file separate returns are each limited to \$12,500 instead of \$25,000, but if either spouse has no carryforward, carryback or current year general business credit in the tax year that ends within or with the other spouse's tax year, the other spouse gets the full amount of \$25,000.

Limitation on Business Credits

- ❖ For estates and trusts, the \$25,000 amount is reduced to an amount equal to \$25,000 multiplied by a fraction (numerator is the total income of the estate or trust not allocated to beneficiaries, denominator is the total income of the estate or trust).

Limitation on Business Credits

- ❖ Net income tax is the sum of the regular tax liability and the alternative minimum tax (AMT), reduced by the credits listed below.
- ❖ Net regular tax is the regular tax liability reduced by the sum of the following credits:
 - ▶ (1) household and dependent care credit
 - ▶ (2) credit for the elderly and the permanently and totally disabled
 - ▶ (3) adoption credit
 - ▶ (4) child tax credit

Limitation on Business Credits

- (5) mortgage credit
- (6) Hope scholarship and lifetime learning credits
- (7) credit for making elective deferrals and IRA contributions
- (8) nonbusiness energy property credit
- (9) residential energy efficient property
- (10) Puerto Rican and possessions tax credits
- (11) alternative fuel production credit
- (12) qualified electric vehicle credit
- (13) Puerto Rico economic activity credit
- (14) alternative motor vehicle credit
- (15) qualified alternative fuel vehicle refueling property credit and
- (16) first-time homebuyer credit for District of Columbia

Limitation on Business Credits

- ❖ The empowerment zone employment credit is limited to the excess of the taxpayer's net income tax over the greater of:
 - ▶ (1) 75% of his tentative minimum tax or
 - ▶ (2) 25% of so much of his net regular tax liability as exceeds \$25,000.
 - ▶ This limitation is reduced by the general credits (not including the empowerment zone employment credit, New York Liberty Zone business employee credit, and other specified credits) allowed for the tax year.
- ❖ The effect is that the empowerment zone employment credit may be used to offset up to 25% of a taxpayer's AMT

Limitation on Business Credits

- ↔ The New York Liberty Zone business employee credit may offset 100% of the taxpayer's AMT.
- ↔ “Specified credits” may offset 100% of a taxpayer's AMT. They include:
 - (1) credits determined under Code Sec. 45 to the extent attributable to electricity or refined coal produced at a facility which is originally placed in service after Oct. 22, 2004 and during the four-year period beginning on the date the facility was originally placed in service and
 - (2) the Code Sec. 40 alcohol fuel credit
 - The Indian coal production credit can also qualify as a specified credit after 2005 for a 4-year period.

Business Tax Credits

- ❖ Work Opportunity
- ❖ Welfare-to-Work
- ❖ Research and Development
- ❖ Empowerment Zone
- ❖ Renewal Community Employment
- ❖ Excise Tax Paid on Telecommunication Services

Work Opportunity & Welfare-to-Work Tax Credits

Form 8850 & Form 8861
Form 8854

Certification

- ❖ For either credit, the eligible employee must be
 - ❖ A new hire and
 - ❖ Certified by their state employment security agency (SESA) that the new hire is a member of a target group

Target Group

- ❖ Qualified IV-A recipients
 - Qualified recipients of aid to families with dependent children or successor program
- ❖ Qualified veterans
- ❖ Qualified ex-felons
- ❖ High-risk youths
- ❖ Vocational rehabilitation referrals
- ❖ Qualified summer youth employees
- ❖ Qualified food stamp recipient and
- ❖ Qualified SSI recipients

Target Group

- ❖ For employees who begin work after 2006, it also includes a long-term family assistance recipient, i.e., a member of a family that receives or received assistance under a IV-A program for a minimum period of time.

Certification

- ❖ To be eligible for the credit, a new employee must be certified as a member of a target group by a SESA
 - No credit is allowed for employees who are related to the employer or to certain owners of the employer.
- ❖ The employer can either:
 - Get the certification by the day the prospective employee begins work or
 - Complete a pre-screening notice (use Form 8850) for the employee by the day he is offered employment, and submit it to the SESA as part of a request for certification within 28 days (21 days for employees who begin work before 2007) after the employee begins work.

Work Opportunity Tax Credit

- ❖ Potential Benefit of \$2,400 per New Eligible Hire.
- ❖ Credit Rate
 - ▶ 25% or 40% of the first \$6000 of Qualified Wages for the First Year of Employment.
- ❖ Carryback 1 Year, Carryforward 20 Years.

Work Opportunity Tax Credit cont.

- ❖ Eligible New Hires:
 - › Welfare Recipients;
 - › 18-24 Year-Old Food Stamp Recipients;
 - › Veterans;
 - › Vocational Rehabilitation Referrals;
 - › 18-24 Year-Old EZ/EC Residents;
 - › 16-17 Year-Old EZ/EC Residents Hired as Summer Youth Employees;
 - › Ex-Felons;
 - › SSI Recipients.

Welfare-To-Work Tax Credit

- ❖ Potential Benefit of \$8,500 per New Eligible Hire Over a 2-Year Period.
- ❖ Credit Rate:
 - ❖ New Hires Must be Employed 400 or More Hours or 180 Days. The Rate is 35% of Qualified Wages* for the First Year of Employment and 50% of Qualified Wages* for the Second Year.
 - * **Qualified Wages are Capped at \$10,000 per Annum for all W2W Target Groups.**
- ❖ Carryback 1 Year, Carryforward 20 Years.

Welfare-To-Work Tax Credit

cont.

- ❖ Eligible New Hires - Long Term Welfare Recipients, Either:
 - Members of a Family That Received Temporary Assistance for Needy Families (“TANF”) for at Least 18 Consecutive Months Before Date of Hire;
 - Members of a Family whose TANF Eligibility Expired Under Federal or State Law After August 5, 1997;
 - Members of a Family That Received TANF for a Total of at Least 18 Months, Beginning After August 5, 1997.

Research and Development Credit

Form 6765

Industries Impacted

- ❖ High-tech manufacturing
- ❖ Contract manufacturing
- ❖ Financial institutions
- ❖ Food processing/manufacturing
- ❖ Medical Device manufacturing
- ❖ Pharmaceuticals and Vitamin manufacturers
- ❖ Software/hardware development
- ❖ Defense contractors
- ❖ Engineering/Architectural firms

Definition/Requirements

“Four Main Requirements”

1. New or Improved Business Component
2. Technological in Nature
3. Elimination of Uncertainty
4. Process of Experimentation

Technological in Nature

- ❖ Principles of the physical or biological sciences, engineering, or computer science.
- ❖ May employ existing technologies and may rely on existing principles.
- ❖ No requirement to succeed.
- ❖ Cannot be in the “soft” sciences.
- ❖ Awarded a patent.

Elimination of Uncertainty

- ❖ Development activities must be intended to discover information that would eliminate uncertainty concerning the development or improvement of a Business Component.

Focus on Uncertainty

❖ Taxpayer is Uncertain:

1. If it can develop the Business Component it wants to develop, or
2. How to develop the Business Component it wants to develop, or
3. Of the appropriate design of the Business Component it wants to develop.

Examples of Qualifying Products

- ❖ Innovative product
- ❖ Engineering and design
- ❖ Research aimed at discovering new knowledge;
- ❖ Ways to apply new research findings;
 - Designing product alternatives;
- ❖ Significant modifications to a concept or design of a product;
- ❖ Designing, constructing and testing reproduction prototypes and models;
- ❖ Engineering activity to advance the product's design
- ❖ Any product where a patent is obtained (or likely to be approved.)

Examples of Qualifying Activities

- ❖ Systems process modeling
- ❖ System and functional requirements analysis
- ❖ Experimentation with new technologies
- ❖ Experimentation with new material to improve manufactured products
- ❖ Performing R&D engineering to evaluate new or improved processes
- ❖ Developing new prototyping and preproduction phases
- ❖ Significantly cut a products time-to-market
- ❖ Obtain more efficient designs

Internal-use Software

- ❖ Developed internally for sale, lease, license, or otherwise marketed for separately stated consideration is not considered internal-use software.
- ❖ All other internally-developed software is classified as internal-use and is non-qualified unless the software:
 - Is used in qualified research for a product or activity

Internal-use Software Development

- ❖ Additional 3 Part Test
- ❖ The software must:
 - Be innovative
 - Involve Significant Economic Risk
 - Be Commercially Unavailable

Qualifying Costs

- ❖ Wages & Compensation
- ❖ Supplies & Cost to fabricate prototypes/items consumed in R&D process
- ❖ 65% of Contract Research to outside consultants/engineers/software developer

Wages for Qualified Services

- ❖ Wages paid to employees engaged in qualified research, direct supervision, and direct support of qualified research activities are eligible for the credit.
- ❖ Indirect activities that qualify must directly benefit the research activities

Supplies

- ❖ Supplies are *tangible personal property* other than
 - Land or improvements to land, and
 - Property of a character subject to allowance for depreciation.
- ❖ Examples can include:
 - General supplies (*i.e.*, pens, paper, disks),
 - Design and construction of prototypes,
 - Extraordinary utilities, and
 - Experimental production lots used to test the appropriateness of a design.

Contract Research Expenditures

- ↔ 65% of amounts paid to anyone (other than an employee) for qualified research or services
- ↔ Contract research for the taxpayer
 - Prior to the performance of qualified research.
 - Must bear the risk of the expense if the research is not successful. (No contingent arrangements for successful completion)

Computation of the Tax Credit

- ❖ Four steps:
 1. Calculate the fixed-base percentage.
 2. Determine the base amount.
 3. Calculate qualified research expenditures.
 4. Calculate the incremental credit amount.

Fixed Base %

- ❖ Ratio of Qualified Research Expenditures (QRE) related to the gross receipts of the applicable base period.
- ❖ Base Period (5 Years); 1984-1988
- ❖ Formula

$$\frac{\text{Total QRE}}{\text{Total Receipts}} = \text{Fixed Base \%}$$

Calculating the Fixed-base % - Example

| Year | QREs | Gross Receipts |
|-------|--------------|-----------------|
| 1984 | \$11,000,000 | \$300,000,000 |
| 1985 | 12,000,000 | 200,000,000 |
| 1986 | 15,000,000 | 200,000,000 |
| 1987 | 18,000,000 | 500,000,000 |
| 1988 | 19,000,000 | 300,000,000 |
| Total | \$75,000,000 | \$1,500,000,000 |

Fixed-Base Percentage = \$75,000,000 / \$1,500,000,000 or 5%.

Calculating the 2006 Base Amount

| Year | Gross Receipts |
|-------------------------------|----------------------|
| 2002 | \$400,000,000 |
| 2003 | 500,000,000 |
| 2004 | 700,000,000 |
| 2005 | 800,000,000 |
| Total | \$2,400,000,000 |
| | / 4 |
| Average Gross Receipts | \$600,000,000 |
| Fixed-Base Percentage | X5% |
| 2006 Base amount | \$30,000,000 |

Calculating the 2006 QREs

| | Total Cost | QREs |
|--------------------------------------------|--------------|--------------|
| Wages Subject to Withholding | \$23,000,000 | \$22,800,000 |
| Fringe Benefits not Subject to Withholding | 2,000,000 | 0 |
| Supplies | 5,700,000 | 5,700,000 |
| Depreciation | 3,000,000 | 0 |
| Overhead | 16,300,000 | 0 |
| Contract Research | 10,000,000 | 6,500,000 |
| Total | \$60,000,000 | \$35,000,000 |

Calculating the 2006 Research Credit

| | |
|-------------------------------|------------------|
| Qualified Research Expenses | \$35,000,000 |
| Less: Base Amount | 30,000,000 |
| Incremental R&D Expenses | 5,000,000 |
| Effective R&D Credit % | @ 13% |
| Federal R&D Credit | \$650,000 |

Note: Effective R&D Credit % assumes either a 35% effective tax rate or a valid 280(C) election.

“Start-up” Base Period

For companies without R&D during at least 3 of 5 years during 1984-1988:

Fixed-based percentage = 3% for 1st 5 taxable years beginning after 12/31/1993.

❖ Rate adjusts in years 6 through 10 (and beyond).

Empowerment Zone Employment Credit

Form 8844

Empowerment Zone

- ❖ Equal to 20% of the qualified zone wages paid or incurred during the calendar year that ends with or within that tax year.
- ❖ The amount of qualified zone wages taken into account for each employee can't exceed \$15,000 for a calendar year.
 - Thus, the maximum credit per qualified employee is \$3,000 per year.

Empowerment Zone

- ❖ Qualified zone wages don't include wages taken into account for the work opportunity or the welfare-to-work credits
- ❖ The \$15,000 maximum amount is reduced by the amount of wages taken into account for the work opportunity credit or the welfare-to-work credit.
- ❖ The employer's deduction for wages paid must be reduced by the empowerment zone employment credit for the year.

Renewal Community Employment Credit

Form 8844

Renewal Community

- ❖ For wages paid or incurred before 2010, a “renewal community” (as designated under Code) is treated, subject to modifications, as an “empowerment zone” for purposes of the empowerment zone tax credit
- ❖ In applying empowerment zone tax credit rules to renewal communities,
 - (1) the credit is 15% of qualified wages, and
 - 2) the maximum amount of qualified wages that can be used to figure the credit is \$10,000 per employee per year.

Renewal Community

- ❖ Qualified wages for purposes of the renewal community employment credit don't include amounts taken into account in figuring the welfare-to-work or work opportunity credit and
- ❖ The \$10,000 of maximum wages per qualified employee is reduced by the amount of wages used to figure either of these credits.

Credit for Federal Telephone Excise Tax Paid

Form 8913

Background

- ❖ In Notice 2006-50, the IRS conceded that telephone communications for which a toll charge varies only with elapsed time, and not distance, is not subject to the telephone excise tax under the Code
- ❖ A refundable tax credit is available for amounts paid for long distance service that was billed to all taxpayers for a 41-month period (February 28, 2003 and before August 1, 2006).

Formula Method

- ❖ The IRS has announced a formula method that corporations, partnerships, and tax-exempt organizations can use to estimate their federal telephone excise tax refunds.
 - Individuals use a table method
- ❖ The formula method is optional.
 - Taxpayers can still choose to document the actual tax paid and request a refund based on the actual amounts

Formula Method

- ❖ Figure the credit by comparing two telephone bills from 2006 to determine the percentage of their telephone expenses attributable to the long-distance excise tax
- ❖ The two bills are
 - ▶ (1) the bill with a statement date in April 2006 and
 - ▶ (2) the bill with a statement date in September 2006.

Formula Method

- ❖ First, figure the telephone tax as a percentage of their April 2006 telephone bills (which included the excise tax for both local and long-distance service) and their September 2006 telephone bills (which only included the tax on local service).
- ❖ Second, the difference between these two percentages should then be applied to the quarterly or annual telephone expenses to determine the amount of their refunds.

Formula Method

- ❖ The credit is capped at 2 percent of the total telephone expenses for corporations, partnerships and tax-exempt organizations with 250 or fewer employees.
- ❖ The refund is capped at 1 percent for those with more than 250 employees.
- ❖ Interest is also owed on the refund.

Claiming the Credit

- ❖ To receive the credit, complete Form 8913 and
 - ▶ Corporations and partnerships should attach it to their 2006 income tax returns
 - ▶ Tax-exempt organizations must attach it to their 2006 Form 990
- ❖ This is a one-time credit to be claimed on 2006 tax returns
- ❖ The credit is refundable to the organization, not a flow through credit to a shareholder or partner.

Need more information?

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Small Business and Work Opportunity Tax Act of 2007

Federal Tax Credit Changes

Work Opportunity Tax Credit

SBWO Act Changes

- ❖ Extended WOTC through August 31, 2011, instead of letting expire on December 31, 2007
- ❖ Effective May 26, 2007, broadened the scope by extending the pool of potential employees who can be hired
- ❖ WOTC can also offset the Alternative Minimum Tax Credit

Research and Development Credit

Form 6765

SWBO Act Changes

- ❖ Beginning in 2007, a new opportunity exists to simplify the process of qualifying for the research credit by electing to use the alternative simplified credit or ASC.
- ❖ The ASC calculation avoids determining the historical based periods for those taxpayers who have never taken the credit.
- ❖ In addition, for those taxpayers whose research expenses no longer exceed the base period hurdle, it provides an opportunity for a reduced credit.

SWBO Act Changes

- ❖ The credit is simply calculated by taking the current year's qualified research expenses less a base amount equal to 50% of the prior 3 years' average qualified research expenses and multiplying that result by 12%.
- ❖ In the event the previous three years qualified research expenses are not available, the taxpayer is still eligible to receive a credit equal to 6% of the current year's qualified research expenses.

SWBO Act Changes

- ❖ Example 1. A manufacturer has \$500,000 of qualified research expenses in 2007. In 2004, 2005, and 2006 the company reported \$100,000, \$200,000, and \$300,000 in qualified research expenses. Using ASC, the manufacturer receives a credit of \$36,000 ($500,000 - 200,000 \times 50\%$ of the prior three year average times 12%) for research credits in 2007.

SWBO Act Changes

- ❖ Example 2. A software developer has \$500,000 of qualified research expenses in 2007. However, the developer did not start business until 2006 so there is only one prior year of qualified expenses. In this case, the software developer receives 6% of 500,000 or \$30,000 of research credits in 2007.

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