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How Life Science Companies Can Benefit From the R&D Tax Credit Now

BY JOHN PENNETT

Introduction

Dating back to 1981, the Research and Development credit (''R&D credit'') was a financial windfall for companies that perform qualified research within the U.S. Fast forward to 2015, the Protecting Americans from Tax Hikes (''PATH'') Act contains several changes to the tax law that impacted individuals, families and businesses—such as protections from tax fraud—as well as extended certain expiring tax laws. Specifically, the PATH Act included various changes to the R&D credit related to payroll taxes and the alternative minimum tax (''AMT'') that are tremendously beneficial for biotech firms—particularly start-ups and small businesses.

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Payroll

The PATH Act enables a qualified small business to elect to claim a certain amount of its R&D credit as a payroll tax credit against its employer portion of FICA liability, rather than carrying the credit forward indefinitely (previously the R&D credits could only be used to offset income taxes due).

A qualified small business for this purpose is defined as a corporation, partnership, LLC or individual that, with respect to any taxable year:

- has gross receipts of less than $5 million and
- did not have gross receipts for *any* taxable year preceding the 5-tax-year period ending with the tax year of the election.

In other words, in order for a company to qualify to utilize the payroll tax offset in 2017, the company must not have more than $5 million of gross receipts in 2016. It must also not have had *any* gross receipts in tax years prior to 2012. The definition of gross receipts is not clearly defined within the section, but many interpretations point to the following guidance: gross receipts include all sales (net of returns and allowances), service income, interest, dividends, rents and royalties, as well as any income from incidental or outside sources.

The amount of the credit is limited to the lesser of $250,000 per year or the amount of the R&D credit computed on the taxpayer's income tax return. Any credit that exceeds the amount of the taxpayer's FICA tax liability in a given quarter may be carried forward to future quarters.

Waveguide

The Waveguide Corp. is a Cambridge, Mass.-based company that developed a handheld diagnostic device designed to diagnose tuberculosis and ovarian cancers. Peter Rock, Waveguide's Vice President of Finance, shared his thoughts on the PATH Act changes: ''Most early stage biotech companies have little or no revenue. Traditional tax incentives are nice, but they don't have much value in the company's early stages of development. Being able to offset payroll taxes with the R&D Credit has an immediate positive impact on cash flow and it makes planning easier.'' Rock mentions that it is also very important for early stage biotechs to monitor and take advantage of any state incentive programs for life sciences, research and development and manufacturing.

Process for Claiming the Payroll Tax Offset:

- Compute the R&D credit on the 2016 or subsequent income tax return on Form 6765.
- Complete Form 8974, which is a new form, to report the credits elected to offset FICA tax. This form is also filed as a component of the company's federal tax return.
- File payroll Form 941 with Form 8974 attached for each quarter that there is an offset.

A taxpayer may only claim the election for five years for a maximum potential credit of $1.25 million. Any election to apply the R&D credit to offset payroll tax cannot be revoked without the consent of the IRS.

These changes afford small businesses and start-ups an excellent opportunity to realize the tax benefit of their R&D credits immediately, whereas in the past they may have had to wait years to reach profitability or even been precluded from using their credits due to various limitations. It gives companies that are incurring losses an instant benefit as well as a great way to conserve cash. R&D credits are normally carried forward for 20 years to offset income tax liability, and there are some companies that have losses for 30 years and some of these R&D credits may expire. This tax savings can also act as an incentive to hire more people.

During the current tax filing season, consideration should be given to the preparation of elections, calculation of the R&D credit and timely filing of the returns in order to enable taxpayers to obtain the largest possible benefit from the new PATH Act rules.

AMT

In the past, the R&D credit could not be used to offset AMT, with limited exceptions. The PATH Act provides the ability for certain taxpayers to utilize the credits to offset both regular tax or AMT for tax credits generated during tax years beginning on or after Jan. 1, 2016. Credits generated in prior years typically will not be eligible to offset AMT, but can continue to be carried forward to offset future regular tax in accordance with previous tax law. The AMT offset is available only to eligible small businesses. Eligible small businesses are those that are a:

- corporation, the stock of which is not publicly traded;
- partnership; or
- sole proprietorship.

In addition, the average annual gross receipts of such corporations, partnerships or sole proprietorships for the 3-taxable-year period preceding the taxable year must not exceed $50 million. For example, if the business wishes to utilize the credit to offset AMT in 2016, its average annual gross receipts for tax years 2013, 2014 and 2015 must not exceed $50 million. Any partner or S corporation shareholder claiming a pass-through credit must also meet the gross receipts test for its pass-through credit to be eligible to offset AMT.

Phosphorus, Inc.

Jack Loprete is the Vice President of Finance for Phosphorus, Inc. This New York City-based company leverages advances in genetic research that identify conditions and diseases in the human genome to develop software and lab test protocols that analyze genetic defects, mutations and abnormalities, giving health-care providers more tools to diagnose and treat conditions and diseases with better outcomes.

How important are these changes to the PATH Act? Loprete says, ''These changes allow biotech ventures to redirect funds previously used to pay taxes to their R&D programs—especially companies with established profitable products already in the market that couldn't previously use the credit to offset AMT. The broader use of credits also gives companies and investors a greater incentive to invest in research rather than funding areas that do not offer credits, like advertising and promotion. So, I think we'll see even more investment money coming into biotech as investors increase the biotech component of their portfolios for these reasons.''

And how will this impact capital raising strategies? According to Loprete, ''Because PATH changes increase the opportunity to offset taxes, companies can now use investor capital more effectively to generate faster and larger ROIs. This, in turn, makes it easier to attract investors and increases valuations, which can reduce dilution. By providing an incremental source of capital, PATH changes reduce the amount of capital companies must raise, and the less capital raising is needed the lower the risk of dilution and the higher the EPS for early investors. Lastly, providing a source of capital that doesn't require a large amount of time and cost to raise reduces transaction costs and allows management to spend less time courting investors and more time managing their existing investments.''

Finally, we asked Loprete how this may change where biotechs do their work—moving from offshore to onshore. ''I don't think it will impact genomic research much, but it may impact other biotech sub-sectors. By incenting companies to research in the U.S. and to use employees or on-shore contractors, recent PATH changes may result in fewer companies seeking offshore resources or establishing offshore research facilities. Staying in the U.S. also allows companies better IP protection. Whenever research involves patient information or use of regulated materials, equipment or reagents, laws and regulations apply. Those rules protect information and prevent violations of privacy or misuse of materials or equipment. For that reason, many companies involved in human genome research feel they can protect information more efficiently here at home.''

Example

Let's examine how one hypothetical biotech company can take advantage of this unique tax savings. It is at the R&D stage of a clinical asset, but has not yet introduced the product to market. There are a number of bench scientists on staff who are developing the asset. The company is based in a renowned incubator in San Francisco, along with other peer companies, and is under the guidance of an advisory board:

Step 1 – Calculate Research and Development Credit

R&D wages - $200,000

Supplies used in R&D - $15,000

Contract research costs - $125,000 (limited to 65 percent of expense incurred)

Assume no gross receipts

Start-up company – 3 percent fixed-based percentage

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Total qualified research expenses = $296,250

Multiply by 50 percent = $148,125

Elect Section 280C (multiply by 13 percent) = $19,250

R&D Credit = $19,250

This credit is computed and reported on Form 6765 and filed with the company's income tax return.

Step 2 – Apply the Credit to Payroll Taxes

Your payroll provider or PEO presently computes the payroll tax liability for most companies, and prepares your Form 941 (quarterly Federal payroll tax form). The employer portion of FICA is typically 6.2 percent of wages up to the FICA base of $118,500 (the projected limit set by the Social Security Administration).

Assume annual employer FICA is $32,000

Employer FICA liability for quarter ended June 30, 2017 = $8,000

Credit Applied on Form 8974 *($8,000)*

Balance of Employer FICA Liability Due = NIL

Employer FICA liability for quarter ended Sept. 30, 2017 = $8,000

Credit Applied on Form 8974 *($8,000)*

Balance of Employer FICA Liability Due = NIL

Employer FICA liability for quarter ended September 30, 2017 = $8,000

Credit Applied on Form 8974 *($3,250)*

Balance of Employer FICA Liability Due = $4,750

Conclusion

These changes to the R&D credit are designed to provide an immediate tax benefit. However, due to the potential complexities involved, it is recommended companies work with their tax advisor.