R&D CREDIT

Overview

- The Research and Experimentation tax credit was originally enacted in 1981 as a temporary provision of U.S. tax law designed to encourage the performance of research and development ("R&D") in the United States. The provision has expired numerous times over the past 32 years, but has continually been extended, occasionally on a retroactive basis. The credit is currently set to expire at the end of 2013.

- There are two methods of determining the credit. Under the basic formula, a 20% credit is based on increases in R&D expenses relative to a taxpayer's sales, as compared to the taxpayer's R&D to sales ratio in the late 1980s. Since this method is complex and dated, many taxpayers use the "alternative simplified" formula. Under the alternative simplified method, the tax credit is equal to 14% of a taxpayer's incremental research expenses in a year, i.e., expenses that exceed 50% of the taxpayer's average research expenses for the preceding 3-year base period.

- Taxpayers are also entitled to a tax ***deduction*** for R&D expenses incurred as ordinary and necessary business expenses in the U.S. However, the tax deduction for R&D expenses is reduced by the amount of the R&D tax credit. Therefore, the basic research credit actually results in a net benefit of 13% (20% benefit reduced by a loss of a 35% deduction on the amount of the credit). Under the alternative simplified formula, the net effect is a tax benefit of 9.1% (14% benefit offset by loss of a 35% deduction on the amount of the credit).

Example of the Alternative Simplified Method

- Taxpayer incurs R&D expenses as follows: $90 in 2010, $110 in 2011, $100 in 2012 and $110 in 2013. Using the alternative simplified method for 2013, 50% of Taxpayer's 3-year base period average is $50 (the base amount). If this reduced credit method is elected, Taxpayer's net R&D credit for 2013 would be 9.1% of the $60 increase in 2013 R&D over the base amount, or approximately $5.

2013 R&D Expense:		$110
Base Period R&D Expense:		
2010	$90	
2011	$110	
2012	$100	
Total	$300	
Average of 3 Prior Years	$100	
Base Amount: 50% of the Prior 3-Year Average		$50
Incremental R&D above Base Amount (for 2013)		$60
R&D Credit @ 9.1% (rounded)		**$5**

Observations

- The R&D tax credit provides a tax benefit only for *increases* in R&D spend, no matter how significant the base amount of R&D in the United States each year.
- The R&D tax credit is intended to incent taxpayers to locate and perform R&D in the United States. However, given the temporary, annually expiring nature of the credit, it is unclear to what extent taxpayers can or will factor the tax credit into long-term decisions about the location of R&D.