

Major Research and Development Expenses Tax Credit Guidelines

Introduction

During the 2016 Session, the General Assembly enacted House Bill 884 (2016 *Acts of Assembly*, Chapter 661) and Senate Bill 58 (2016 *Acts of Assembly*, Chapter 300), which established the Major Research and Development Expenses Tax Credit. This is an individual and corporate income tax credit for certain taxpayers that incur Virginia qualified research and development expenses in excess of \$5 million during a taxable year.

These guidelines are published by the Department to provide guidance to taxpayers regarding the Major Research and Development Expenses Tax Credit. These guidelines are not rules or regulations subject to the provisions of the Administrative Process Act (*Va. Code* § 2.2-4000 et seq.) and are being published in accordance with the Tax Commissioner's general authority to supervise the administration of the tax laws of the Commonwealth pursuant to *Va. Code* § 58.1-202. As necessary, additional information will be published and posted on the Department's website, www.tax.virginia.gov. These guidelines are separate from the Research and Development Expenses Tax Credit Guidelines. Those guidelines are contained in a separate document.

These guidelines represent the Department's interpretation of the relevant laws. They do not constitute formal rulemaking and hence do not have the force and effect of law or regulation. In the event that the final determination of any court holds that any provision of these guidelines is contrary to law, taxpayers who follow these guidelines will be treated as relying on erroneous written advice for purposes of waiving penalty and interest under *Va. Code* §§ 58.1-105, 58.1-1835, and 58.1-1845. To the extent there is a question regarding the application of these guidelines, taxpayers are encouraged to write to the Department and seek a written response to their question.

General Overview

Effective for taxable years beginning on or after January 1, 2016, Virginia allows an individual and corporate income tax credit for incurring more than \$5 million of Virginia qualified research and development expenses during a taxable year. The amount of the credit is equal to 10 percent of the difference between:

- The Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year; and
- 50 percent of the average Virginia qualified research and development expenses paid or incurred by the taxpayer for the three taxable years immediately preceding the taxable years.

If a taxpayer did not pay or incur Virginia qualified research and development expenses in any one of the three taxable years immediately preceding the taxable year for which the credit is being determined, the credit is equal to 5 percent of the Virginia qualified research and development expenses paid or incurred by the taxpayer during the relevant taxable year.

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The credit is allowed for the same calendar year in which qualified research and development expenses are reported on the federal income tax return (“the credit year”), in accordance with the taxpayer’s accounting method.

Annual Credit Cap

The credit is capped at \$20 million per taxable year. If total eligible credit requests exceed \$20 million, each taxpayer will be granted a pro rata amount of credits as determined by the Department. The prorated credit amount will be determined by multiplying the amount of credits requested by an eligible taxpayer for the taxable year by a fraction, the numerator of which is the \$20 million credit cap, and the denominator of which is the total amount of credits requested by all eligible taxpayers for such taxable year.

Annual Credit Limitation and Carryover Credits

The credit amount claimed by a taxpayer cannot exceed 75 percent of the taxpayer’s Virginia income tax liability for the taxable year. Any credit not usable for the taxable year for which the credit was first allowed may be carried over for credit against the income taxes of the taxpayer in the next 10 succeeding taxable years, or until the total amount of the credit has been taken, whichever is sooner.

Requirements to Qualify for the Tax Credit

Research Must Meet the Federal Definition for “Qualified Research”

The research of a taxpayer applying for the Major Research and Development Expenses Tax Credit must meet the federal definition of qualified research under IRC § 41(d) to qualify for the credit. Under IRC § 41(d), qualified research means research:

- With expenditures that qualify as expenses under Internal Revenue Code (“IRC”) § 174 (i.e. such expenditures must be incurred in connection with the taxpayer’s trade or business and represent a research and development cost in the experimental or laboratory sense);
- That is undertaken for the purpose of discovering information which is technological in nature;
- The application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and
- Substantially all of the activities of which constitute elements of a process of experimentation for a new or improved function, performance, or reliability or quality.

To be considered “qualified research,” the taxpayer must establish that the research being performed meets each of the above requirements.

Qualified research generally does not include the following:

- Research conducted after the beginning of commercial production;

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- Research adapting an existing product or process merely to meet customer specifications (unless the adaptation is carried out under experimental or laboratory conditions in order to improve the product or process, or to develop a new use for the product or process);
- Duplication of an existing business activity;
- Surveys, studies or routine activities, including: testing, or inspection of materials or products for quality control; environmental analysis; testing of samples for chemical or other content; operations research; feasibility studies; efficiency surveys; management studies; consumer surveys; economic surveys; research in the social sciences; market research including advertising and promotions; and routine data collection;
- Research in the social sciences, arts, or humanities;
- Research conducted outside the United States, Puerto Rico, or a United States possession;
- Research of computer software for internal use (except if the software development contributes to Virginia qualified research and development); or
- Any research and development that is already funded by a grant, contract or another entity, including a governmental entity.

Expenses Must Meet the Federal Definition for “Qualified Research Expenses”

Virginia research and development expenses must meet the federal definition of qualified research expenses under IRC § 41(b) to qualify for the credit. Under IRC § 41(b), qualified research expenses are defined as amounts paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer for:

- In-house expenses; and
- Contract research expenses.

Under IRC § 41(b)(2), in-house expenses consist of the following:

- Wages, as defined in IRC § 3401(a) or earned income, as defined in 401(c)(2), paid or incurred to an employee, except for wages used to determine the federal work opportunity credit under IRC § 51(a);
- Amounts paid or incurred for supplies used in the conduct of qualified research, except for land or land improvements and property that is subject to depreciation, that are used in research and development; and

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- Amounts paid or incurred to another person or business for the right to use computers in the conduct of qualified research.

Under IRC § 41(b)(3), contract research expenses consist of the following:

- 65 percent of any amount paid or incurred by a taxpayer to a person (other than an employee of the taxpayer) for qualified research;
- 75 percent of any amount paid or incurred by a taxpayer to a qualified research consortium for qualified research; and
- 100 percent of any amount paid or incurred to an eligible small business, an institution of higher education (as defined in IRC § 3304(f)), or an organization that is a federal laboratory (as defined in IRC § 3304(f)).

See IRC § 41 and the regulations thereunder for additional requirements regarding qualified research expenses.

Example 1: Computation of Contract Research Expenses, Part I

Taxpayer A paid \$10,000,000 to a contractor to conduct qualified research in Virginia. Therefore, Taxpayer A has Virginia qualified research and development expenses equal to:

$$65\% \times \$10,000,000 = \mathbf{\$6,500,000}$$

This amount can then be used by Taxpayer A in computing its Major Research and Development Expenses Tax Credit.

Example 2: Computation of Contract Research Expenses, Part II

Taxpayer B paid \$5,000,000 to a contractor to conduct qualified research in Virginia. Taxpayer B has no other Virginia qualified research and development expenses. Therefore, Taxpayer B has Virginia qualified research and development expenses equal to:

$$65\% \times \$5,000,000 = \mathbf{\$3,250,000}$$

Because Taxpayer B's Virginia qualified research and development expenses do not exceed \$5 million, it may not claim the Major Research and Development Expenses Tax Credit. Taxpayer B may instead claim the Research and Development Expenses Tax Credit to the extent it qualifies for such credit.

Research Must be Conducted in Virginia

A taxpayer applying for the Major Research and Development Expenses Tax Credit must ensure that the research and development expenses it uses toward the credit are attributable to research conducted in Virginia. Research is conducted in Virginia to the extent that it is conducted at a research laboratory, office, plant, or other facility located in

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Virginia, regardless of whether the organization conducting the research is organized under the laws of Virginia or another jurisdiction. If research is conducted jointly at research facilities located within and outside of Virginia, the research and development expenses include only the payments attributable to the portion of the qualified research conducted within Virginia. Only the wages paid for research that was conducted in Virginia may be included as wages that qualify for the credit.

Disqualified Research Expenses

Research and development expenses that are paid or incurred for research conducted in Virginia on human cells or tissue derived from induced abortions or from stem cells obtained from embryos do not qualify for the credit. Research and development expenses that are paid or incurred for research conducted in Virginia on nonhuman embryonic stem cells may qualify for the credit.

Interaction with Other Virginia Tax Credits

Research and development expenses that are used as the basis for claiming Major Research and Development Expenses Tax Credits may not be used as the basis for claiming any other Virginia income tax credit. However, a taxpayer may be allowed to use the same research and development expenses that were used as the basis for claiming the federal credit for increasing research activities under IRC § 41 to claim the Major Research and Development Expenses Tax Credit. No taxpayer may claim both the Major Research and Development Expenses Tax Credit and the Research and Development Expenses Tax Credit for the same taxable year.

Computation of the Credit

The procedure for computing the credit amount is derived from the procedure for determining the federal alternative simplified credit for increasing research activities under IRC § 41(c)(5). The credit is determined as follows:

- Step 1** Determine the total amount of Virginia qualified research and development expenses for the credit year.
 - a. If such expenses are in excess of \$5 million, go to Step 2.
 - b. If such expenses are equal to or less than \$5 million, stop. The taxpayer may not claim the Major Research and Development Expenses Tax Credit. The taxpayer may instead claim the Research and Development Expenses Tax Credit to the extent that it qualifies for such credit.

- Step 2** Determine whether the taxpayer paid or incurred Virginia qualified research and development expenses in each of the three immediately preceding taxable years.
 - a. If the taxpayer paid or incurred such expenses for each of the three preceding taxable years, determine the average of such amounts and multiply the result by 50%. Then go to Step 3.

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- b. If the taxpayer did not pay or incur such expenses in any one of the three preceding taxable years, go to Step 5.

Step 3 From the amount of Virginia qualified research and development expenses determined in Step 1, subtract the amount computed in Step 2a.

- a. If zero or less than zero, stop. You do not qualify for the credit.

- b. If greater than zero, proceed to Step 4.

Step 4 If determined in Step 2a that the taxpayer paid or incurred Virginia qualified research and development expenses in each of the three preceding taxable years, the credit is equal to 10 percent of the amount determined in Step 3.

Step 5 If the taxpayer determined in Step 2b that the taxpayer did not pay or incur Virginia qualified research and development expenses in each of the three preceding taxable years, the credit is equal to 5 percent of the amount determined in Step 1.

If the total eligible credit requests exceed \$20 million, the amount of credits granted to each taxpayer will be prorated.

Example 3: Computation of the Credit, Part I

Taxpayer D has \$8 million in Virginia qualified research and development expenses in Taxable Year 2016. Taxpayer D's Virginia qualified research and development expenses for the three preceding taxable years are: \$6 million in Taxable Year 2013, \$7 million in Taxable Year 2014, and \$5 million in Taxable Year 2015.

Following Step 2a above, Taxpayer D must determine the average amount of the Virginia research and development expenses it incurred for the three preceding taxable years, and multiply the result by 50 percent:

$$\$6 \text{ million} + \$7 \text{ million} + \$5 \text{ million} = \mathbf{\$18 \text{ million}}$$

$$\frac{\$18 \text{ million}}{3} \times 50\% = \mathbf{\$3 \text{ million}}$$

Following Step 3 above, subtract the amount determined in Step 2a from the Virginia qualified research and development expenses:

$$\$8 \text{ million} - \$3 \text{ million} = \mathbf{\$5 \text{ million}}$$

Following Step 4 above, Taxpayer D may claim a credit equal to:

$$10\% \text{ of } \$5 \text{ million} = \mathbf{\$500,000}.$$

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Example 4: Computation of the Credit, Part II

Taxpayer E has \$12 million in Virginia qualified research and development expenses in 2016. Taxpayer E's Virginia qualified research and development expenses for the three preceding taxable years: \$0 in Taxable Year 2013, \$11.5 million in Taxable Year 2014, and \$11 million in Taxable Year 2015.

Because Taxpayer E did not pay or incur Virginia qualified research and development expenses in each of the three preceding taxable years, following Step 5 above, Taxpayer E may claim a credit equal to:

$$5\% \text{ of } \$12 \text{ million} = \mathbf{\$600,000}.$$

Example 5: Proration of Credit Amounts

Assume the same facts as in Example 4, except the Department receives \$25 million in eligible credit requests for Taxable Year 2016. Because the total amount of eligible credit requests exceeds the \$20 million credit cap, the credit Taxpayer E may claim for Taxable Year 2016 must be proportionately reduced as follows:

$$(\$20 \text{ million} / \$25 \text{ million}) \times \$600,000 = \mathbf{\$480,000}.$$

Short Taxable Year

The method for computing the Major Research and Development Expenses Tax Credit when the credit year or any relevant preceding taxable year is a short taxable year is derived from the procedure for computing the federal alternative simplified credit for increasing research activities under Treas. Reg. § 1.41-9(c)(3)(i). In the case of a short taxable year, only the Virginia research and development expenses from the taxable year encompassed in the short taxable year return may be taken into account for that taxable year. This procedure only applies to taxpayers that paid or incurred Virginia qualified research and development expenses in each of the three taxable years immediately preceding the credit year. It does not apply if the taxpayer did not pay or incur Virginia qualified research and development expenses in any one of the three immediately preceding taxable years.

If the credit year is a short taxable year, then the average amount of Virginia qualified research and development expenses for the three years preceding the credit year must be modified by multiplying that amount by the number of days in the short taxable year and dividing the result by 365 (366 in a leap year). Treas. Reg. § 1.41-9(c)(3)(i).

If one or more of the three taxable years preceding the credit year is a short taxable year, then the Virginia qualified research and development expenses for such year must be modified by multiplying that amount by 365 (366 in a leap year) and dividing the result by the number of days in the short taxable year. Treas. Reg. § 1.41-9(c)(3)(i).

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Example 6: Credit Computation When Credit Year is a Short Taxable Year

Taxpayer F has \$4 million in Virginia qualified research and development expenses in a short taxable year beginning on January 1, 2017 and ending on June 30, 2017. Taxpayer F's Virginia qualified research and development expenses for the three preceding taxable years are: \$9 million in Taxable 2014, \$8 million in Taxable Year 2015, and \$7 million in Taxable Year 2016.

Following Step 2a above, Taxpayer F must determine the average amount of the Virginia research and development expenses it incurred for the three preceding taxable years, and multiply the result by 50%:

$$\$9 \text{ million} + \$8 \text{ million} + \$7 \text{ million} = \mathbf{\$24 \text{ million}}$$

$$\frac{\$24 \text{ million}}{3} \times 50\% = \mathbf{\$4 \text{ million}}$$

Because the credit year is a short taxable year, Taxpayer F must modify the average amount of Virginia qualified research and development expenses for the three preceding taxable years by multiplying that amount by, 273, the number of days in the short taxable year, and dividing the result by 365:

$$\$4 \text{ million} \times (181/365) = \mathbf{\$1,983,562}$$

Following Step 3 above, subtract the amount determined in Step 2a from the Virginia qualified research and development expenses:

$$\$4 \text{ million} - \$1,983,562 = \mathbf{\$2,016,438}$$

Following Step 4 above, Taxpayer F may claim a credit equal to:

$$10\% \text{ of } \$2,016,438 = \mathbf{\$201,644}$$

Example 7: Credit Computation When Prior Year is a Short Taxable Year

Taxpayer G has \$15 million in Virginia qualified research and development expenses in 2016. Taxpayer G elected to compute the Major Research and Development Expenses Tax Credit Taxpayer G's Virginia qualified research and development expenses for the three immediately preceding taxable year are: \$4 million in a short taxable year beginning on October 1, 2013 and ending on December 31, 2013, \$10 million in Taxable Year 2014, and \$12 million in Taxable Year 2015.

For purposes of determining the average amount of Virginia qualified research and development expenses Taxpayer G incurred for the three preceding taxable years, the amount of Virginia research and development expenses it incurred during the short taxable year must be modified by multiplying that amount by 365 and dividing the result by 92, the number of days in the short taxable year:

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$$\frac{\$4 \text{ million} \times 365}{92} = \mathbf{\$15,869,565}$$

Following Step 2a above, Taxpayer G must determine the average amount of the Virginia qualified research and development expenses it incurred for the three preceding taxable years, and multiply the result by 50%:

$$\$15,869,565 + \$10 \text{ million} + \$12 \text{ million} = \mathbf{\$37,869,565}$$

$$\frac{\$37,869,565}{3} \times 50\% = \mathbf{\$6,311,594}$$

Following Step 3 above, subtract the amount determined in Step 2a from the Virginia qualified research and development expenses:

$$\$15 \text{ million} - \$6,311,594 = \mathbf{\$8,688,406}$$

Following Step 4 above, Taxpayer G may claim a credit equal to the lesser of:

$$10\% \text{ of } \$8,688,406 = \mathbf{\$868,841}$$

Combining the Activities of Entities

Neither the Virginia qualified research and development expenses nor the gross receipts of two or more separate pass-through or corporate entities may be combined for purposes of determining the amount of the credit. Each corporation in a group of affiliated corporations that files a combined or consolidated return is required to compute the credit separately. The total amount of credits allowed to each corporation in a group of affiliated corporations may be aggregated on a combined or consolidated return. The Virginia qualified research and development expenses and gross receipts of a disregarded entity may be combined with the Virginia qualified research and development expenses and gross receipts of its parent entity for purposes of determining the amount of the credit.

Corporate Restructuring

A taxpayer that acquires or disposes of a trade or business or a separate unit of a trade or business in the credit year, or in any relevant preceding taxable year, must compute the credit using the procedures set forth in IRC § 41(f)(3)(ii).

Application and Filing Requirements

An eligible taxpayer must submit an Application for the Major Research and Development Expenses Tax Credit, Form MRD, and any supporting documentation to the Department no later than July 1 of the year following the credit year. The Department will review all applications for completeness and notify taxpayers of any errors by September 1. If any additional information is required, it must be provided to the Department no later than September 15 to be considered for the credit. All eligible taxpayers will then be notified as to the amount of credits that they may claim.

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Upon receiving notification of the credit amount from the Department, the taxpayer must claim the credit on the appropriate Virginia income tax return. In the event that a taxpayer does not receive notification of the allowable credit amount before its Virginia income tax return is due, the taxpayer may file the return during the extension period, or it may file the original return without claiming the credit and then file an amended tax return once notification of the allowable credit amount is received.

Fiscal Year Filers

A taxpayer is a fiscal year filer if its taxable year consists of any period other than a calendar year (January 1 to December 31). A fiscal year filer is required to claim the credit for the calendar year in which its taxable year ends (“the credit year”). When determining its Virginia qualified research and development expenses for the credit year, a fiscal year filer must include such expenses incurred during the calendar year in which its taxable year ends. Such amount will include Virginia qualified research and development expenses from portions of two taxable years. When determining the amount of the credit, a fiscal year filer must determine the amount of Virginia qualified research and development expenses it incurred during the three preceding taxable years, beginning with the taxable year ending in the calendar year immediately preceding the credit year.

Example 8: Credit Computation for Fiscal Year Filers

Taxpayer H is a fiscal year filer with a taxable year that begins on August 1, and ends on July 31. Taxpayer H had \$25 million in Virginia qualified research and development expenses in Calendar Year 2016. Taxpayer H’s Virginia qualified research and development expenses for the three preceding taxable years beginning with its taxable year ending in the first calendar year prior to the credit year are: \$18 million in Taxable Year 2012; \$21 million in Taxable Year 2013; and \$27 million in Taxable Year 2014.

Following Step 2a above, Taxpayer H must determine the average amount of the Virginia qualified research and development expenses it incurred for the three preceding taxable years, and multiply the result by 50%:

$$\$18 \text{ million} + \$21 \text{ million} + \$27 \text{ million} = \mathbf{\$66 \text{ million}}$$

$$\frac{\$66 \text{ million}}{3} \times 50\% = \mathbf{\$11 \text{ million}}$$

Following Step 3 above, subtract the amount determined in Step 2a from the Virginia qualified research and development expenses:

$$\$25 \text{ million} - \$11 \text{ million} = \mathbf{\$14 \text{ million}}$$

Following Step 4 above, Taxpayer H may claim a credit equal to:

$$10\% \text{ of } \$14 \text{ million} = \mathbf{\$1.4 \text{ million}}$$

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Pass-Through Entities

A pass-through entity that is granted Major Research and Development Expenses Tax Credits is required to submit a completed Form PTE to the Department allocating credits to its partners, members, or shareholders in proportion to their ownership interest in the entity, or in accordance with a written agreement entered into by such individual partners, members, or shareholders.

Documentation and Record Keeping

A taxpayer must attach documentation to the application that outlines the type of research conducted in Virginia and substantiates the calculation of the credit. Further, a taxpayer that is headquartered outside of Virginia, but has employees in Virginia or contracts with an entity conducting research in Virginia, must attach documentation to the application regarding where the research was conducted, how much time was spent conducting the research, and the type of research that was conducted.

On request, a taxpayer paying wages to individuals performing Virginia qualified research on its behalf may be required to provide adequate documentation that substantiates the allocation of wages for Virginia qualified research and development expenses. Such documentation includes, but is not limited to, name, taxpayer identification number, detailed job description, gross Virginia wages, time cards, internal written documents that verify the percentage of time devoted to Virginia qualified research, and a detailed description of each department or business unit performing Virginia qualified research and the nature of the research performed.

In order to verify that its research and development expenses qualify for the credit, a taxpayer may be required to provide proofs of purchase such as invoices, receipts, cancelled checks, bank statements, or credit card statements to the Department on request. Taxpayers applying for the credit may be required to provide additional documentation to the Department as deemed necessary.

Additional Information

These guidelines are available online under the Laws, Rules and Decisions section of the Department's website, located at <http://www.policylibrary.tax.virginia.gov>. For additional information, please contact the Department at (804) 367-8037.

Approved:



Craig M. Burns
Tax Commissioner