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Taking Credit

2016 Federal & California Business Tax Credits Update

Recent developments in federal and California business tax credits offer opportunities to reduce or eliminate taxes, but many of these programs are poorly understood and underutilized. We will examine several of the credits available to business taxpayers.

Tax Credits 101

A tax credit is a dollar-for-dollar offset of tax liability and more valuable than a deduction that simply lowers taxable income. The business tax credits that are the focus of this article are nonrefundable credits. As a result, taxpayers do not receive an immediate benefit if the credits are not utilized in the current year. These credits are not refunded, but will be applied against tax liability in future periods.

In some cases, the credits do not expire, while others have a limited term. There also may be an opportunity to amend prior year returns to claim the credits and request refunds. Lastly, many states, including California, allow tax credits to be assigned to other members of a combined reporting group.

PATH

The Protecting Americans from Tax Hikes Act (PATH) of 2015 was signed into law in December 2015 and included several provisions that are beneficial to taxpayers beginning in 2016.

For example, the R&D tax credit was retroactively renewed and is now permanent. This credit rewards businesses that develop new or innovative products, as well as those making process improvements that are technological in nature. The credit had previously expired on 16 separate occasions, only to be retroactively renewed with a one-year lapse during 1995-96.

Another component of PATH is a provision to allow businesses (and business owners) to claim the R&D tax credit against AMT if annual gross receipts do not exceed $50 million. In addition, startup businesses with less than $5 million in gross receipts

beginning in the 2016 tax year that also have no gross receipts for the prior five-year period can offset up to $250,000 of the employer portion of OASDI (Social Security tax).

The PATH Act also extended the Work Opportunity Tax Credit (WOTC) through Dec. 31, 2019.

The WOTC rewards employers hiring individuals from targeted groups that have traditionally faced barriers to employment and is administered by the California Employment Development Department.

The credit is available to both for-profit businesses and tax-exempt organizations.

PATH expanded the targeted groups to include long-term unemployment recipients hired on or after Jan. 1, 2016. Long-term unemployment (LTU) employees must have been unemployed at least 27 consecutive weeks and received federal or state unemployment compensation prior to being hired.

The Department of Labor later released Training and Employment Guidance Letter No. 25-15, which provides guidance on claiming the WOTC for LTU new hires. The DOL also published new forms that include the LTU category.

IUS

The R&D tax credit rules generally prohibit time and expense incurred in the development of internal-use software with certain exceptions. The final regulations (TD 9786) issued on Oct. 3, address various items regarding internal-use software for purposes of claiming the R&D tax credit and slightly modify the proposed regulations (REG-153656-03) published in Jan. 2015.

Prior to the proposed regulations, the IRS waited more than a decade to offer guidance on internal-use software. The final regulations:

- Define internal-use software and adjust the definition of non-IUS;
- Provide that certain IUS is eligible for the R&D tax credit if the software satisfies the high threshold of innovation test;
- Expand the concept of uncertainty in the "significant economic risk" prong of the high threshold of innovation test;
- Provide that certain software enabling communication with third parties is not subject to the definition of IUS and must meet only the general four-part test;
- Provide rules for computer software that is developed for both internal use and non-internal use (dual-function computer software);
- Include examples to illustrate application of the regulations for internal-use software; and
- Limit the definition of "general and administrative functions."

The final regulations are effective for tax years beginning on or after Oct. 4, 2016, but taxpayers can generally rely on either the proposed or final regulations for tax years ending after Jan. 20, 2015.

GO-Biz

California has attempted to improve its business climate by introducing various tax incentives. In 2011, Gov. Brown established the Governor's Office of Business and Economic Development (GO-Biz) as California's lead entity for business and job creation efforts. The governor signed AB 93 and SB 90 into law on July 11, 2013. This legislation repealed the Enterprise Zone program and introduced the California Competes Tax Credit (CCTC), New Employment Credit (NEC) and the partial sales or use tax exemption (SUT) as part of the Governor's Economic Development Initiative.

The CCTC rewards businesses that relocate to California or remain and expand in the state. Tax credit agreements are negotiated by GO-Biz and approved the CCTC Committee for tax years beginning on or after Jan. 1, 2014, and before Jan. 1, 2025.

The most competitive applications are evaluated based on the factors required by statute including total jobs created, investment in the state and economic impact.

Larger businesses (e.g., Tesla, Northrop Grumman, Samsung, Nordstrom, etc.) have received a significant portion of the CCTC each year, but 25 percent of the credits are reserved for small businesses.

The credits are awarded over three separate rounds of applications each fiscal year. GO-Biz has budgeted $243.3 million tax credits for 2016-17 and the two remaining rounds of applications are scheduled as follows:

- Jan. 2-23 ($100 million available);
- March 6-27 ($68.3 million, plus any remaining unallocated amounts).

GO-Biz (*www.business.ca.gov*) filed proposed amendments to the regulations for the CCTC program with the Office of Administrative Law on July 26.

The proposed amendments include the following:

- Allow applications for the CCTC to automatically move into the Phase II review process if at least 50 percent of the net increase of full-time employees work in an area of high unemployment or poverty;
- Add a new question to the CCTC application relating to the hiring and recruiting practices of businesses applying for the credit;
- Clarify the definition of salary; and
- Make other technical amendments.

Although the NEC is a valuable hiring credit that can be more than $70,000 per qualified employee, it has a number of restrictions that limit its application. It's only available to businesses located in a Designated Geographic Area within California and the requirements for both employers and employees are quite onerous. In fact, the FTB website lists only $299,164 NEC claims in 2014. That is approximately 1.36 percent of the $22 million originally projected. The FTB has indicated there may be forthcoming changes in the program to promote its use.

The partial SUT has been more successful and is available for the purchase or lease of property used primarily (more than 50 percent) in manufacturing or R&D that is acquired through June 30, 2022.

The Board of Equalization exempts the state portion (4.1875 percent) of the sales or use tax with a $200 million limit on exempt purchases each year.

Conclusion

There are a number of tax credits available to businesses in almost every industry that practitioners should consider for their clients. Documentation and record keeping are imperative with all of the tax credits. It's not what you claim; it's what you keep. CPA

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