COMMONWEALTH of VIRGINIA

Department of Taxation

TO: Jay Doshi
Director, Special Taxes and Services

FROM: Mark C. Haskins
Director, Policy Development Division

DATE: May 22, 2013

RE: First-Year Companies Claiming the Research and Development Expenses Tax Credit

ISSUE

Policy Development recently received questions regarding whether a company that is in its first year of operation may claim the Virginia Research and Development Expenses Tax Credit and how such company should compute the amount of the tax credit.

ANALYSIS

A company is eligible to claim the Virginia Research and Development Expenses Tax Credit for qualified research expenses incurred during its first year of operation. Under *Va. Code* § 58.1-439.12:08, a taxpayer may claim a Virginia Research and Development Expenses Tax Credit equal to either 15 percent or 20 percent of its qualified research and development expenses, to the extent that such expenses exceed its Virginia base amount.

"Virginia base amount" is defined in *Va. Code* § 58.1-439.12:08 to mean the base amount as defined in IRC § 41(c) that is attributable to Virginia by (i) substituting "Virginia qualified research and development expense" for "qualified research expense;" (ii) substituting "Virginia qualified research" for "qualified research;" and (iii) instead of the federal definition of "fixed-base percentage," using the following:

1) The percentage that the Virginia qualified research and development expense for the three taxable years immediately preceding the current taxable year in which the expense is incurred is of the taxpayer's total gross receipts for such years; or

2) The percentage that the Virginia qualified research and development expense for the applicable number of taxable years immediately preceding the current taxable year in which the expense is incurred is of the taxpayer's total gross receipts for such years, for the taxpayer that has fewer than three but at least one prior taxable year.

Because the second formula applies only to taxpayers that have fewer than three, but at least one prior taxable year, all other taxpayers would compute this percentage using the first formula. If a taxpayer was not in existence prior to the current taxable year, then both the Virginia qualified research and development expense for the three immediately preceding taxable years and the taxpayer's gross receipts for such years would be zero. Since both the numerator and denominator would be zero, the Virginia percentage that replaces the federal fixed-base percentage would be equal to zero percent.

In IRC § 41(c), "base amount" is defined as the product of:

A) The fixed-base percentage; and

B) The average annual gross receipts of the taxpayer for the four taxable years preceding the taxable year for which the tax credit is being determined.

Under Treas. Reg. § 1.41-3(a), if a taxpayer was not in existence prior to the current taxable year, the average annual gross receipts of the taxpayer for the four taxable years preceding the tax credit year is zero. Therefore, the average annual gross receipts for a company in its first year of operation will always equal zero.

Because the Virginia base amount is determined by multiplying the Virginia formula above by the taxpayer's average annual gross receipts, the Virginia base amount for such businesses would be zero. However, under IRC § 41(c)(2), the base amount may never be less than 50 percent of the taxpayer's qualified research expenses for the tax credit year. As a consequence, companies that are in their first year of operation will always have a base amount equal to 50 percent of their Virginia qualified research and development expenses.

If you have any questions, please call Matt Huntley at (804) 786-2010.

c: Larry Durbin
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