

Research and Development Expenses Tax Credit Guidelines (For Taxable Years Beginning Before January 1, 2016)

Introduction

During the 2011 Session, the Virginia General Assembly enacted House Bill 1447 (2011 Acts of Assembly, Chapter 742) and Senate Bill 1326 (2011 Acts of Assembly, Chapter 745), which established the 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.

During the 2014 Session, the Virginia General Assembly enacted House Bill 1220 (2014 Acts of Assembly, Chapter 227) and Senate Bill 623 (2014 Acts of Assembly, Chapter 306), which increase the annual credit cap, increase the thresholds for computing the credit, and allow pass-through entities to elect to claim the credit at the entity level. These bills also require taxpayers to provide certain information to the Department of Taxation (“the Department”) when applying for the credit and require the Department to disclose certain information to the General Assembly regarding the credit upon request.

These guidelines are published by the Department to provide guidance to taxpayers regarding the Research and Development Expenses Tax Credit, and incorporate both the 2011 and 2014 legislation regarding the 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 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

Under *Va. Code* § 58.1-439.12:08, Virginia allows a refundable individual and corporate income tax credit for conducting qualified research and development in Virginia, to the extent a taxpayer’s Virginia qualified research and development expenses exceed its Virginia base amount. The credit is allowed in the taxable 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. The Research and Development Expenses Tax Credit is comprised of a base credit and a supplemental credit that is available only to the extent that the total amount of credits granted for a fiscal year is less than the annual credit cap. For Taxable Year 2014 and thereafter, the credit cap is \$6 million. For Taxable Years 2011 through 2013, the credit cap was \$5 million.

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Base Credit Amount

Effective for Taxable Year 2014 and thereafter, the base credit is equal to: (i) 15 percent of the first \$234,000 in Virginia qualified research and development expenses paid or incurred by the taxpayer during the credit year, or (ii) 20 percent of the first \$234,000 in Virginia qualified research and development expenses paid or incurred by the taxpayer during the credit year if the Virginia qualified research was conducted in conjunction with a Virginia public or private college or university, to the extent such expenses exceed the taxpayer's Virginia base amount.

If the total eligible credit requests exceed the \$6 million credit cap for all credits, each taxpayer will be granted a pro rata amount of credits as determined by the Department. The amount of the prorated credit will be determined by multiplying the amount of credits requested by the eligible taxpayer for the taxable year by a fraction, the numerator of which is the \$6 million credit cap, and the denominator of which is the total amount of credits requested by all eligible taxpayers for such taxable year.

For Taxable Years 2011 through 2013, the base credit was equal to: (i) 15 percent of the first \$167,000 in Virginia qualified research and development expenses paid or incurred by the taxpayer during the credit year, or (ii) 20 percent of the first \$175,000 in Virginia qualified research and development expenses paid or incurred by the taxpayer during the credit year if the Virginia qualified research was conducted in conjunction with a Virginia public or private college or university, to the extent such expenses exceed the taxpayer's Virginia base amount.

Supplemental Credit Amount

For Taxable Year 2014 and thereafter, if the total amount of approved credits for all applications for any taxable year is less than the \$6 million credit cap, the Department will allocate credits up to the \$6 million credit cap, on a pro rata basis, to taxpayers that are already approved for the credit but whose credit was previously limited by the cap. The supplemental credit is generally equal to 15 percent of the second \$234,000 in Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year in excess of its Virginia base amount. However, if a taxpayer's base credit was based on Virginia qualified research that was conducted in conjunction with a Virginia public or private college or university, then its supplemental credit is equal to 20 percent of the second \$234,000 in Virginia qualified research and development expenses conducted in conjunction with a Virginia public or private college or university paid or incurred by the taxpayer during the taxable year in excess of its Virginia base amount.

If there are sufficient funds available, the amount of supplemental credits allowed to each eligible taxpayer will be determined by the Department based on information supplied on the taxpayer's credit application.

For Taxable Years 2011 through 2013, if the total amount of approved credits for all applications for any taxable year was less than the \$5 million credit cap, the Department

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allocated credits up to the \$5 million credit cap, on a pro rata basis, to taxpayers who were already approved for the credit. This supplemental allocation of credits for the taxable year was equal to: (i) 15 percent of the second \$167,000 in Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year in excess of the Virginia base amount, or (ii) 20 percent of the second \$175,000 in Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year in excess of the Virginia base amount if the Virginia qualified research was conducted in conjunction with a Virginia public or private college or university.

Refundability of the Credit

The Research and Development Expenses Tax Credit is generally a refundable credit. Therefore, if the amount of credit that a taxpayer is allowed to claim exceeds the taxpayer's tax liability for the taxable year, then the excess amount of credit will be refunded to the taxpayer.

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. However, if a taxpayer engages in research in Virginia on human cells or tissue derived from induced abortions or from stem cells obtained from human embryos, it may receive a nonrefundable credit for other Virginia qualified research and development expenses. If the amount of nonrefundable credit that a taxpayer is allowed to claim exceeds the taxpayer's tax liability for the taxable year, then the excess amount of credit will not be refunded to the taxpayer and cannot be carried over to future taxable years.

Research and development expenses that are paid or incurred for research conducted in Virginia on nonhuman embryonic stem cells may qualify for the credit.

Requirements to Qualify for the Tax Credit

Research Must Meet the Federal Definition for “Qualified Research”

The research of a taxpayer applying for the 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 respect to which expenditures may be treated as expenses under IRC § 174. To qualify as an expense under IRC § 174, an expenditure 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.
- Which is undertaken for the purpose of discovering information which is technological in nature;

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- 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;
- 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.

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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
- 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.

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Example 1: Computation of Contract Research Expenses

Taxpayer F paid \$100,000 to a contractor to conduct qualified research in Virginia. Therefore, Taxpayer F has Virginia qualified research and development expenses equal to:

$$65\% \times \$100,000 = \mathbf{\$65,000}$$

This amount can then be used by Taxpayer F in computing his Research and Development Expenses Tax Credit.

Research Must be Conducted in Virginia

A taxpayer applying for the 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 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.

Criteria for Virginia Qualified University Expenses

A taxpayer that conducts Virginia qualified research in conjunction with a college or university may qualify for an enhanced credit equal to 20% of its Virginia qualified research and development expenses, provided that the academic institution is a Virginia public or private college or university included on the State Council of Higher Education for Virginia's list of Virginia public and private colleges and universities.

If a taxpayer has contracted with a public or private college or university in Virginia that conducts research in multiple states, only the expenses from research and development conducted in Virginia may qualify for the credit.

A taxpayer applying for the credit using Virginia qualified university expenses must provide evidence of contracting with the academic institution to the Department when applying for the credit. Evidence of contracting with a Virginia public or private college or university includes a formal agreement that outlines the type of research to be conducted and is signed by the taxpayer, or an authorized officer of the taxpayer, and a qualified person from the academic institution. The taxpayer must also provide evidence to the Department of payments made or incurred by the taxpayer to the academic institution when applying for the credit.

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Interaction with Other Virginia Tax Credits

Research and development expenses that are used as the basis for claiming Research and Development Expenses Tax Credits may not be used as the basis for claiming any other Virginia income tax credit. However, a taxpayer will 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 Virginia Research and Development Expenses Tax Credit.

Computation of the Credit

The procedure for computing the amount of the Research and Development Expenses Tax Credit is derived from the federal procedure for computing the federal credit for increasing research activities under IRC § 41. For taxable years beginning on or after January 1, 2014, the computation of the credit is as follows:

- Step 1** Determine the total amount of Virginia qualified research and development expenses for the credit year.
- Step 2** Determine the amount of Virginia qualified research and development expenses for the credit year that are from Virginia qualified research conducted in conjunction with a Virginia public or private college or university (“Virginia qualified university expenses”).
- Step 3** Determine the fixed-base percentage:
 - a. Determine the amount of Virginia qualified research and development expenses for the three taxable years preceding the credit year. If the taxpayer has been in business for fewer than three taxable years, but at least one taxable year, use the Virginia qualified research and development expenses for the taxable years it has been in business.
 - b. Determine the amount of gross receipts for the three taxable years preceding the credit year. If the taxpayer has been in business for fewer than three taxable years, but at least one taxable year, use the total amount of gross receipts for the taxable years it has been in business.
 - c. Calculate the fixed-base percentage by dividing the amount determined in Step 3a by the amount determined in Step 3b.
- Step 4** Determine the Virginia base amount:
 - a. Determine the average amount of gross receipts for the four taxable years preceding the credit year. If the taxpayer has been in existence for fewer than four taxable years, but at least one taxable year, determine the average amount of gross receipts for the number of years it has been in existence.
 - b. Multiply the fixed-base percentage in Step 3c by the amount determined in Step 4a.

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- c. The Virginia base amount is the greater of:
 - i. The amount determined in Step 4b or
 - ii. 50% of the Virginia qualified research and development expenses determined in Step 1.

Step 5 From the amount of Virginia qualified research and development expenses determined in Step 1, subtract the Virginia base amount computed in Step 4c.

- a. If zero or less than zero, stop. There are no research and development expenses that qualify for the credit.
- b. If greater than zero, proceed to compute the amount of the credit.

Step 6 The credit is the greater of:

- a. 15% times the lesser of (i) the amount computed in Step 5 or (ii) \$234,000 or
- b. 20% times the lesser of (i) the amount determined in Step 2 or (ii) \$234,000.

If the total eligible credit requests exceed the \$6 million credit cap, the amount of credits granted to each taxpayer will be prorated.

Step 7 If the total amount of approved credits for all applications for any taxable year is less than the \$6 million credit cap, the supplemental credit allowed to each taxpayer will be determined by the Department as follows:

- a. If the taxpayer's base credit was equal to 15% of its Virginia qualified research and development expenses, its supplemental credit will be equal to 15% times the lesser of:
 - i. The amount computed in Step 5 in excess of \$234,000 or
 - ii. \$234,000.
- b. If the taxpayer's base credit was equal to 20% of its Virginia qualified university expenses, its supplemental credit will be equal to 20% times the lesser of:
 - i. The amount computed in Step 2 in excess of \$234,000 or
 - ii. \$234,000.

If the Department determines that taxpayers are eligible for supplemental credits that, when combined with the total amount of approved base credits, exceed the \$6 million credit cap, the amount of supplemental credits granted to each taxpayer will be prorated.

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Example 2: Computation of Fixed-Base Percentage

Taxpayer A had \$750,000 in Virginia qualified research and development expenses in 2014. Taxpayer A's Virginia qualified research and development expenses for the three taxable years immediately preceding the credit year are: \$450,000 in 2011; \$500,000 in 2012; and \$550,000 in 2013. Taxpayer A's total gross receipts for the four taxable years immediately preceding the credit year are: \$10 million in 2010, \$12 million in 2011, \$14 million in 2012, and \$16 million in 2013.

Following Step 3 above, Taxpayer A's fixed-base percentage is computed as follows:

- a. Determine the amount of Virginia qualified research and development expenses for the three taxable years preceding the credit year:

$$\$450,000 + \$500,000 + \$550,000 = \mathbf{\$1.5 \text{ million}}$$

- b. Determine the amount of gross receipts for the three taxable years preceding the credit year:

$$\$12 \text{ million} + \$14 \text{ million} + \$16 \text{ million} = \mathbf{\$42 \text{ million}}$$

- c. Calculate the fixed-base percentage by dividing the amount of Virginia qualified research and development expenses for the three taxable years preceding the credit year by the amount of gross receipts for the three taxable years preceding the credit year:

$$\frac{\$1.5 \text{ million}}{\$42 \text{ million}} = \mathbf{3.57\%}$$

Example 3: Computation of Virginia Base Amount

Assume the same facts as in Example 2. Following Step 4 above, Taxpayer A's Virginia base amount is computed as follows:

- a. Determine the average amount of gross receipts for the four taxable years preceding the credit year:

$$\frac{\$10 \text{ million} + \$12 \text{ million} + \$14 \text{ million} + \$16 \text{ million}}{4} = \mathbf{\$13 \text{ million}}$$

- b. Multiply the fixed-base percentage determined in Step 3 (see Example 1) by the average amount of gross receipts determined in Step 4a:

$$3.57\% \times \$13 \text{ million} = \mathbf{\$464,100}$$

- c. The Virginia base amount is equal to the greater of:

\$464,100 or

$$50\% \times \$750,000 = \$375,000$$

Taxpayer A's Virginia base amount is **\$464,100**.

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Example 4: Computation of the Credit

Using the fixed-base percentage and Virginia base amount computed in Examples 2 and 3, Taxpayer A's Research and Development Expenses Tax Credit is computed by following Steps 5 and 6:

- a. Subtract the Virginia base amount from the Virginia qualified research and development expenses:

$$\$750,000 - \$464,100 = \mathbf{\$285,900}$$

- b. The credit is equal to 15% of the lesser of \$285,900 or \$234,000:

$$15\% \text{ of } \$234,000 = \mathbf{\$35,100}$$

Example 5: Computation of Credit Amount for University Research, Part I

Assume the same facts as in Example 4, except that \$150,000 of Taxpayer A's \$750,000 in Virginia qualified research and development expenses were Virginia qualified university expenses.

Following Step 6 above, Taxpayer A may claim a credit equal to the greater of:

$$15\% \text{ of the lesser of } \$285,900 \text{ or } \$234,000 = 15\% \times \$234,000 = \mathbf{\$35,100} \text{ or}$$

$$20\% \text{ of the lesser of } \$150,000 \text{ or } \$234,000 = 20\% \times \$150,000 = \mathbf{\$30,000}$$

Therefore, Taxpayer A's credit for Taxable Year 2014 is **\$35,100**.

Example 6: Computation of Credit Amount for University Research, Part II

Assume the same facts as in Example 4, except that \$200,000 of Taxpayer A's \$750,000 in Virginia qualified research and development expenses were Virginia qualified university expenses.

Following Step 6 above, Taxpayer A may claim a credit equal to the greater of:

$$15\% \text{ of the lesser of } \$285,900 \text{ or } \$234,000 = 15\% \times \$234,000 = \mathbf{\$35,100} \text{ or}$$

$$20\% \text{ of the lesser of } \$200,000 \text{ or } \$234,000 = 20\% \times \$200,000 = \mathbf{\$40,000}$$

Therefore, Taxpayer A's credit for Taxable Year 2014 is **\$40,000**.

Example 7: Computation of Supplemental Credit Amount

Assume the same facts as in Example 4, and that the Department approved \$5 million in credits for Taxable Year 2014. Because the total amount of approved credits was less than the \$6 million credit cap, the Department will allocate supplemental credits of up to \$1 million, on a pro rata basis, to taxpayers that are already approved for the credit. Assume that, before proration, taxpayers are eligible for supplemental credits totaling \$3 million for Taxable Year 2014.

Taxpayer A had \$285,900 in Virginia qualified research and development expenses in excess of its Virginia base amount (see Example 3). \$234,000 was

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used in computing Taxpayer A's base credit. Following Step 7 above, the amount of Virginia qualified research expenses that Taxpayer A may use toward the supplemental credit are equal to:

$$\$285,900 - \$234,000 = \mathbf{\$51,900}$$

Because Taxpayer A's base credit was equal to 15 percent of its Virginia qualified research and development expenses, it will be allowed a supplemental credit computed as follows:

$$15\% \times \$51,900 = \mathbf{\$7,785}$$

Because taxpayers are eligible for supplemental credits totaling more than \$1 million, Taxpayer A's allocation of supplemental credits must be reduced proportionately as follows:

$$(\$1 \text{ million} / \$3 \text{ million}) \times \$7,785 = \mathbf{\$2,595}$$

Therefore, Taxpayer A's supplemental credit for Taxable Year 2014 is \$2,595. When Taxpayer A's \$2,595 supplemental credit is combined with its \$35,100 base credit, its total credit for Taxable Year 2014 is **\$37,695**.

Example 8: Proration of Credit Amounts

Assume the same facts as in Example 4, except the Department received \$9 million in eligible credit requests for Taxable Year 2014.

Because the total amount of eligible credit requests exceeds the \$6 million credit cap, the credit Taxpayer A may claim for Taxable Year 2014 must be proportionately reduced as follows:

$$(\$6 \text{ million} / \$9 \text{ million}) \times \$35,100 = \mathbf{\$23,400}$$

Short Taxable Year

The procedure for computing the Research and Development Expenses Tax Credit when the credit year or any relevant preceding taxable year is less than 12 months ("short taxable year") is derived from the federal procedure for computing the federal credit for increasing research activities under Treasury Regulation ("Treas. Reg.") § 1.41-3(b). In the case of a short taxable year, only the total gross receipts and 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.

If the credit year is a short taxable year, then the Virginia base amount must be modified by multiplying that amount by the number of months in the short taxable year, and dividing the result by 12. See Treas. Reg. § 1.41-3(b)(1). This modification may not be used to reduce the Virginia base amount to less than 50 percent of the taxpayer's Virginia qualified research and development expenses for the credit year.

For purposes of determining the Virginia base amount, if any of the taxable years preceding the credit year that must be accounted for when computing the credit is a short taxable year, the gross receipts for such year(s) are deemed to be equal to the

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gross receipts actually derived in that year, multiplied by 12, and divided by the number of months in that year. See Treas. Reg. § 1.41-3(b)(2).

No adjustment to the computation of a taxpayer's fixed-base percentage may be made to account for a short taxable year. See Treas. Reg. § 1.41-3(b)(3).

Example 9: Credit Computation When Credit Year is a Short Taxable Year

Taxpayer D had \$250,000 in Virginia qualified research and development expenses in a short taxable year beginning on January 1, 2014 and ending on October 31, 2014. Taxpayer D's Virginia qualified research and development expenses for the three taxable years immediately preceding the credit year are \$100,000 in 2011, \$200,000 in 2012, and \$300,000 in 2013. Taxpayer D's total gross receipts for the four taxable years immediately preceding the credit year are \$11 million in 2010, \$12 million in 2011, \$14 million in 2012, and \$10 million in 2013.

Following Step 3 above without making modifications to account for the short taxable year, Taxpayer D's fixed-base percentage is computed as follows:

- a. Determine the amount of Virginia qualified research and development expenses for the three taxable years preceding the credit year:

$$\$100,000 + \$200,000 + \$300,000 = \mathbf{\$600,000}$$

- b. Determine the amount of gross receipts for the three taxable years preceding the credit year:

$$\$12 \text{ million} + \$14 \text{ million} + \$10 \text{ million} = \mathbf{\$36 \text{ million}}$$

- c. Calculate the fixed-base percentage by dividing the amount of Virginia qualified research and development expenses for the three taxable years preceding the credit year by the amount of gross receipts for the three taxable years preceding the credit year:

$$\frac{\$600,000}{\$36 \text{ million}} = \mathbf{1.67\%}$$

Following Step 4 above, Taxpayer D's Virginia base amount is computed as follows:

- a. Determine the average amount of gross receipts for the four taxable years preceding the credit year:

$$\frac{\$11 \text{ million} + \$12 \text{ million} + \$14 \text{ million} + \$10 \text{ million}}{4} = \mathbf{\$11.75 \text{ million}}$$

- b. Multiply the fixed-base percentage determined in Step 3 by the average amount of gross receipts determined in Step 4a:

$$1.67\% \times \$11.75 \text{ million} = \mathbf{\$196,225}$$

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- c. The Virginia base amount is equal to the greater of:

\$196,225 or

$50\% \times \$250,000 = \$125,000$

Taxpayer D's Virginia base amount is **\$196,225**.

Because the credit year is a short taxable year, Taxpayer D's Virginia base amount must be modified, but cannot be reduced below \$125,000 because such modification may not be used to reduce the Virginia base amount to less than 50 percent of the taxpayer's Virginia qualified research and development expenses for the credit year:

$\$196,225 \times (10/12) = \mathbf{\$163,521}$

Taxpayer D's Research and Development Expenses Tax Credit is then computed as follows:

- a. Subtract the Virginia base amount from the Virginia qualified research and development expenses:

$\$250,000 - \$163,521 = \mathbf{\$86,479}$

- b. The credit is equal to 15% of the lesser of \$86,479 or \$234,000:

$15\% \times \$86,479 = \mathbf{\$12,972}$

Example 10: Credit Computation When Prior Year is a Short Taxable Year

Taxpayer E had \$250,000 in Virginia qualified research and development expenses in 2014. Taxpayer E's Virginia qualified research and development expenses for the three taxable years immediately preceding the credit year are \$100,000 in 2011, \$200,000 in 2012, and \$300,000 in 2013. Taxpayer E's total gross receipts for the four taxable years immediately preceding the credit year are \$4 million in a short taxable year beginning on August 1, 2010 and ending on December 31, 2010, \$12 million in 2011, \$14 million in 2012, and \$10 million in 2013.

Following Step 3 above without making modifications to account for the short taxable year, Taxpayer E's fixed-base percentage is computed as follows:

- a. Determine the amount of Virginia qualified research and development expenses for the three taxable years preceding the credit year:

$\$100,000 + \$200,000 + \$300,000 = \mathbf{\$600,000}$

- b. Determine the amount of gross receipts for the three taxable years preceding the credit year:

$\$12 \text{ million} + \$14 \text{ million} + \$10 \text{ million} = \mathbf{\$36 \text{ million}}$

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- c. Calculate the fixed-base percentage by dividing the amount of Virginia qualified research and development expenses for the three taxable years preceding the credit year by the amount of gross receipts for the three taxable years preceding the credit year:

$$\frac{\$600,000}{\$36 \text{ million}} = \mathbf{1.67\%}$$

For purposes of determining Taxpayer E's Virginia base amount **ONLY**, its gross receipts for the short taxable year beginning on August 1, 2010 and ending on December 31, 2010 must be annualized as follows:

$$\frac{\$4 \text{ million} \times 12 \text{ months}}{5 \text{ months}} = \mathbf{\$9.6 \text{ million}}$$

Following Step 4 above, Taxpayer E's Virginia base amount is computed as follows:

- a. Determine the average amount of gross receipts for the four taxable years preceding the credit year:

$$\frac{\$9.6 \text{ million} + \$12 \text{ million} + 14 \text{ million} + 10 \text{ million}}{4} = \mathbf{\$11.4 \text{ million}}$$

- b. Multiply the fixed-base percentage by the average gross receipts determined in Step 4a:

$$1.67\% \times \$11.4 \text{ million} = \mathbf{\$190,380}$$

- c. The Virginia base amount is equal to the greater of:

\$190,380 or

$$50\% \times \$250,000 = \$125,000$$

Taxpayer E's Virginia base amount is **\$190,380**

Taxpayer E's Research and Development Expenses Tax Credit is then computed as follows:

- a. Subtract the Virginia base amount from the Virginia qualified research and development expenses:

$$\$250,000 - \$190,380 = \mathbf{\$59,620}$$

- b. The credit is equal to 15% of the lesser of \$59,620 or \$234,000:

$$15\% \times \$59,620 = \mathbf{\$8,943}$$

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.

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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).

Application and Filing Requirements

An eligible taxpayer must submit an Application for the Research and Development Expenses Tax Credit, Form RDC and any supporting documentation to the Department no later than April 1 of the year following the credit year. The Department will review all applications for completeness and notify taxpayers of any errors by June 1. If any additional information is required, it must be provided to the Department no later than June 15 to be considered for the credit. All eligible taxpayers will be notified by June 30 as to the amount of credits that they may claim.

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). For Taxable Year 2012 and thereafter, a taxpayer that is a fiscal year filer will be required to apply for the credit for the calendar year in which its fiscal year ends.

When determining its Virginia qualified research and development expenses for the credit year, a fiscal year filer must include all of the Virginia qualified research and development expenses it 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 of the fiscal year filer's taxable years.

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When computing its fixed-base percentage, a fiscal year filer must determine the amount of Virginia qualified research and development expenses and gross receipts it incurred during the three preceding taxable years beginning with the fiscal year filer's taxable year ending in the first calendar year prior to the credit year. When computing its Virginia base amount, a fiscal year filer must determine the amount of gross receipts it incurred during the four preceding taxable years beginning with the fiscal year filer's taxable year ending in the first calendar year prior to the credit year.

Example 11: Credit Computation for Fiscal Year Filers

Taxpayer G is a fiscal year filer with a taxable year that begins on July 1, and ends on June 30. Taxpayer G had \$500,000 in Virginia qualified research and development expenses in 2014. Taxpayer G'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: \$300,000 in 2010; \$250,000 in 2011; and \$400,000 in 2012. Taxpayer G's total gross receipts for the four preceding taxable years beginning with its taxable year ending in the first calendar year prior to the credit year are: \$8 million in 2009, \$6 million in 2010, \$10 million in 2011, and \$8 million in 2012.

Taxpayer G's fixed-base percentage is computed as follows:

- a. Determine the amount of Virginia qualified research and development expenses for the three taxable years preceding the credit year:

$$\$300,000 + \$250,000 + \$400,000 = \mathbf{\$950,000}$$

- b. Determine the amount of gross receipts for the three taxable years preceding the credit year:

$$\$6 \text{ million} + \$10 \text{ million} + \$8 \text{ million} = \mathbf{\$24 \text{ million}}$$

- c. Calculate the fixed-base percentage by dividing the amount of Virginia qualified research and development expenses for the three taxable years preceding the credit year by the amount of gross receipts for the three taxable years preceding the credit year:

$$\frac{\$950,000}{\$24 \text{ million}} = \mathbf{3.96\%}$$

Taxpayer G's Virginia base amount is computed as follows:

- a. Determine the average amount of gross receipts for the four taxable years preceding the credit year:

$$\frac{\$8 \text{ million} + \$6 \text{ million} + \$10 \text{ million} + \$8 \text{ million}}{4} = \mathbf{\$8 \text{ million}}$$

- b. Multiply the fixed-base percentage determined in Step 3 by the average amount of gross receipts determined in Step 4a:

$$3.96\% \times \$8 \text{ million} = \mathbf{\$316,800}$$

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- c. The Virginia base amount is equal to the greater of:

\$316,800 or

$50\% \times \$500,000 = \$250,000$

Taxpayer G's Virginia base amount is **\$316,800**.

Taxpayer G's Research and Development Expenses Tax Credit is computed as follows:

- a. Subtract the Virginia base amount from the Virginia qualified research and development expenses:

$\$500,000 - \$316,800 = \mathbf{\$183,200}$

- b. The credit is equal to 15% of the lesser of \$183,200 or \$234,000:

$15\% \times \$183,200 = \mathbf{\$27,480}$

For Taxable Year 2011, fiscal year filers were required to modify their Virginia base amount by multiplying the Virginia base amount by the number of months in the fiscal year filer's taxable year that began in Calendar Year 2011 that fell within Calendar Year 2011, and dividing the result by 12. This modification could not be used to reduce the Virginia base amount to less than 50 percent of the taxpayer's Virginia qualified research and development expenses for the credit year.

Pass-Through Entities

Credits granted to a pass-through entity are generally required to be allocated to the 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. 2014 House Bill 1220 and Senate Bill 623 allow a pass-through entity to claim Research and Development Expenses Tax Credits at the entity level in lieu of allocating such credits to the individual partners, members, or shareholders. If a pass-through entity wishes to claim this credit at the entity level without allocating the credit to its owners, the pass-through entity must enter the amount of credit available on Form 502.

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, including its Virginia fixed-base percentage and Virginia base amount. 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

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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.

A taxpayer that applies for a 20% credit based on Virginia qualified university expenses must attach any documentation that substantiates such research, including contracts or agreements between the taxpayer and the Virginia public or private college or university, and an account of the expenses that have been paid or incurred.

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.

Pursuant to 2014 House Bill 1220 and Senate Bill 623, the Department must collect, aggregate, and summarize certain information regarding the Research and Development Expenses Tax Credit, and provide that information to the Governor and any member of the General Assembly on request, regardless of the number of taxpayers that apply for the credit in a taxable year. In order for the Department to fulfill those requirements, a taxpayer that is applying for the credit must also attach documentation to the application setting forth:

- The number of full-time employees employed by the taxpayer in the Commonwealth during the credit year;
- The taxpayer's sector or sectors according to the 2012 edition of the North American Industry Classification System (NAICS) as published by the United States Census Bureau; and
- A brief description of the area, discipline, or field of Virginia qualified research performed by the taxpayer.

Taxpayers applying for the credit may be required to provide additional documentation to the Department as deemed necessary.

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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:

A handwritten signature in black ink, appearing to read "Craig M. Burns". The signature is written in a cursive style with a long horizontal flourish extending to the right.

Craig M. Burns
Tax Commissioner