Research and Development Expenses Tax Credit Guidelines
(Updated July 7, 2020)

Introduction

During the 2011 Session, the 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 increased the annual credit cap, increased the thresholds for computing the credit, allowed pass-through entities to elect to claim the credit at the entity level, and imposed certain reporting requirements. During the 2016 Session, the Virginia General Assembly enacted House Bill 884 (2016 Acts of Assembly, Chapter 661) and Senate Bill 58 (2016 Acts of Assembly, Chapter 300), which further increased the annual credit cap and thresholds for computing the credit, and allowed a taxpayer to elect to determine the credit using an alternative simplified method. During the 2020 Session, the General Assembly enacted House Bill 748 (2020 *Acts of Assembly*, Chapter 469) and Senate Bill 110 (2020 *Acts of Assembly*, Chapter 470), which increase the annual credit cap, change the deadline for submitting credit applications, and extend the sunset date for the credit.

These guidelines are published by the Department of Taxation ("the Department") to provide updated guidance regarding the Research and Development Expenses Tax Credit for taxable years beginning on or after January 1, 2020. 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 Major 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

The Research and Development Expenses Tax Credit is a refundable individual and corporate income tax credit for conducting qualified research and development in Virginia. 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. 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 base credits granted for a fiscal year is less than the annual credit cap. A taxpayer may compute the base credit using the primary method for determining the credit or elect to compute the base credit using the alternative simplified method ("simplified method") for determining the credit.

Base Credit Amount - Primary Method

The base credit for a taxpayer using the primary method is equal to: (i) 15 percent of the Virginia qualified research and development expenses paid or incurred by the taxpayer during the credit year (up to a $45,000 credit), or (ii) 20 percent of the 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 (up to a $60,000 credit), to the extent such expenses exceed the taxpayer's Virginia base amount.

Base Credit Amount - Simplified Method

The base credit for a taxpayer that elects to utilize the simplified method 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 immediately preceding taxable years.

If a taxpayer did not pay or incur Virginia qualified research and development expenses in any one of the three preceding taxable years, the base 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. The annual base credit amount allowed may not exceed (i) $45,000 or (ii) $60,000 if the Virginia qualified research was conducted in conjunction with a Virginia public or private college or university.

Annual Credit Cap

For taxable years beginning on and after January 1, 2021, the annual credit cap increases to $7.77 million per taxable year.

For taxable years beginning on or after January 1, 2016, before January 1, 2021, the credit is capped at $7 million per taxable year. If total eligible credit requests exceed $7 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 $7 million credit cap, and the denominator of which is the total amount of credits requested by all eligible taxpayers for such taxable year.

Supplemental Credit Amount

If the total amount of approved tax credits is less than the credit cap ($7 million credit cap for taxable years beginning on or after January 1, 2016, but before January 1, 2021, and $7.77 million for taxable years beginning on or after January 1, 2021), the Department will allocate the remaining amount, on a pro rata basis, to taxpayers already approved for the credit that were subject to the $45,000 and $60,000 credit limitations. Supplemental credits will be in the following amounts:

- If a taxpayer elected the primary method for determining the credit, an amount equal to 15 percent of the second $300,000 in qualified research expenses, or an amount equal to 20 percent of the second $300,000 in such expenses if the taxpayer's base credit was based on Virginia qualified research that was conducted in conjunction with a Virginia public or private college or university; or

- If the taxpayer elected the alternative simplified method for determining the credit, in an amount equal to the excess of the applicable limitation to the base credit amount.

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 engaged 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.

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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 Internal Revenue Code (“IRC”) § 41(d) to qualify for the credit. Under IRC § 41(d), qualified research means research:

- With expenditures that qualify as expenses under 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;

- 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

- 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

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

65% x $100,000 = **$65,000**

This amount can then be used by Taxpayer A in determining 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.

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 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 Virginia Research and Development Expenses Tax Credit. No taxpayer may claim both the Research and Development Expenses Tax Credit and the Major Research and Development Expenses Tax Credit for the same taxable year.

Computation of the Credit - Primary Method

The primary method for computing the Research and Development Expenses Tax Credit is derived from the procedure for determining the federal credit for increasing research activities under IRC § 41(a). Such computation 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 immediately preceding taxable years. 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 immediately preceding taxable years. 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 immediately preceding taxable years. 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.

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. You do not qualify for the credit using the primary method.

b. If greater than zero and you have Virginia qualified university expenses (see Step 2), proceed to Step 6. If greater than zero and you do not have Virginia qualified university expenses (see Step 2), proceed to Step 7.

Step 6 Determine the amount of Virginia qualified university expenses in excess of the Virginia base amount.

a. Compute the percentage of expenses attributable to Virginia qualified university expenses by dividing the amount of Virginia qualified university expenses from Step 2 by the total amount of Virginia qualified research and development expenses from Step 1.

b. Multiply the percentage from Step 6a by the Virginia base amount determined in Step 4c.

c. From the amount of Virginia qualified university expenses determined in Step 2, subtract the amount computed in Step 6b.

Step 7 The base credit is the greater of:

a. 15% times the lesser of (i) the amount computed in Step 5 or (ii) $300,000; or

b. 20% times the lesser of (i) the amount determined in Step 6c or (ii) $300,000.

Example 2: Computation of Fixed-Base Percentage

Taxpayer B has $850,000 in Virginia qualified research and development expenses in Taxable Year 2016. Taxpayer B's Virginia qualified research and development expenses for the three preceding taxable years are: $450,000 in Taxable Year 2013, $500,000 in Taxable Year 2014, and $550,000 in Taxable Year 2015. Taxpayer B's total gross receipts for the four preceding taxable years are: $10 million in Taxable Year 2012, $12 million in Taxable Year 2013, $14 million in Taxable Year 2014, and $16 million in Taxable Year 2015.

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

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

   $450,000 + $500,000 + $550,000 = **$1.5 million**

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

   $12 million + $14 million + $16 million = **$42 million**

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

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

Example 3: Computation of Virginia Base Amount

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

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

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

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% x 13 million = **$464,100**

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

   $464,100 or

   50% x $850,000 = $425,000

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

Example 4: Computation of the Credit

Using the fixed-base percentage and Virginia base amount computed in Examples 2 and 3, Taxpayer B's Research and Development Expenses Tax Credit is computed by following Steps 5 and 7:

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

   $850,000 - $464,100 = **$385,900**

b. The base credit is equal to 15% of the lesser of $385,000 or $300,000:

   15% of $300,000 = **$45,000**

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 B's $850,000 in Virginia qualified research and development expenses were Virginia qualified university expenses. Following Step 6 above, the amount of Virginia qualified research and development expenses in excess of the Virginia base amount that are attributable to Virginia qualified university expenses is determined as follows:

a. Divide the Virginia qualified university expenses by the total amount of Virginia qualified research and development expenses:

   $150,000/$850,000 = **17.65%**

b. Multiply the percentage determined in Step 6a by the Virginia base amount determined in Step 4c to determine the excess amount attributable to Virginia qualified university expenses:

17.65% x $464,100 = **$81,914**

c. Subtract the amount computed in Step 6b from the amount of Virginia qualified university expenses determined in Step 2

$150,000 - $81,914 = **$68,086**

Following Step 7 above, Taxpayer B may claim a base credit equal to the greater of:

15% of the lesser of $385,900 or $300,000 = 15% x $300,000 = **$45,000** or

20% of the lesser of $68,086 or $300,000 = 20% x $68,086 = **$13,617**

Therefore, Taxpayer B's base credit for Taxable Year 2016 is **$45,000**.

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

Assume the same facts as in Example 4, except that $600,000 of Taxpayer B's $850,000 in Virginia qualified research and development expenses were Virginia qualified university expenses. Following Step 6 above, the amount of Virginia qualified research and development expenses in excess of the Virginia base amount that are attributable to Virginia qualified university expenses is computed as follows:

a. Divide the Virginia qualified university expenses by the total amount of Virginia qualified research and development expenses:

$600,000/$850,000 = **70.59%**

b. Multiply the percentage determined in Step 6a by the Virginia base amount determined in Step 4c to determine the excess amount attributable to Virginia qualified university expenses:

70.59% x $464,100 = **$327,608**

c. Subtract the amount computed in Step 6b from the amount of Virginia qualified university expenses determined in Step 2

$600,000 - $327,608 = **$272,392**

Following Step 7 above, Taxpayer B may claim a base credit equal to the greater of:

15% of the lesser of $385,900 or $300,000 = 15% x $300,000 = **$45,000** or

20% of the lesser of $272,392 or $300,000 = 20% x $272,392 = **$54,478**

Therefore, Taxpayer B's base credit for Taxable Year 2016 is **$54,478**.

Example 7: Computation of Supplemental Credit Amount

Assume the same facts as in Example 4, and that the Department approved $6 million in base credits for Taxable Year 2016. Because the total amount of approved base credits was less than the $7 million credit cap for such taxable year, the Department will allocate supplemental credits of up to $1 million, on a pro rata basis, to taxpayers that are already approved for the base credit. Assume that, before proration, taxpayers are eligible for supplemental credits totaling $3 million for Taxable Year 2016.

Taxpayer B had $385,900 in Virginia qualified research and development expenses in excess of its Virginia base amount (see Example 3). $300,000 was used in computing Taxpayer B's base credit. Therefore, the amount of Virginia qualified research expenses that Taxpayer B may use toward the supplemental credit is computed as follows:

$385,900 - $300,000 = **$85,900**

Because Taxpayer B'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% x $85,900 = **$12,885**

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

($1 million / $3 million) x $12,885 = **$4,295**

Therefore, Taxpayer B's supplemental credit for Taxable Year 2016 is $4,295. When Taxpayer B's $4,295 supplemental credit is combined with its $45,000 base credit, its total credit for Taxable Year 2016 is **$49,295**.

Example 8: Proration of Base Credit Amounts

Assume the same facts as in Example 4, except the Department received $9 million in eligible base credit requests for Taxable Year 2016. Because the total amount of eligible base credit requests exceeds the $7 million credit cap for such taxable year, the base credit Taxpayer B may claim for Taxable Year 2016 must be proportionately reduced as follows:

($7 million / $9 million) x $45,000 = **$35,000**.

Because eligible base credit requests for Taxable Year 2016 exceeded the $7 million credit cap for such taxable year, taxpayers are ineligible for supplemental credits.

Short Taxable Year

The method 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 preceding taxable years 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 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 C had $250,000 in Virginia qualified research and development expenses in a short table year beginning on January 1, 2016 and ending on October 31, 2016. Taxpayer C's Virginia qualified research and development expenses for the three preceding taxable years are $100,000 in Taxable Year 2013, $200,000 in Taxable Year 2014, and $300,000 in Taxable Year 2015.

Taxpayer C's total gross receipts for the four preceding taxable years are $11 million in Taxable Year 2012, $12 million in Taxable Year 2013, $14 million in Taxable Year 2014, and $10 million in Taxable Year 2015.

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

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

   $100,000 + $200,000 + $300,000 = **$600,000**

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

   $12 million + $14 million + $10 million = **$36 million**

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

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

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

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

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

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

   1.67% x $11.75 million = **$196,225**

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

   $196,225 or

   50% x $250,000 = $125,000

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

Because the credit year is a short taxable year, Taxpayer C'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 x (10/12) = **$163,521**

Taxpayer C'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 = **$86,479**

b. The credit is equal to 15% of the lesser of $86,479 or $300,000:

   15% x $86,479 = **$12,972**

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

Taxpayer D had $250,000 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 $100,000 in Taxable Year 2013, $200,000 in Taxable Year 2014, and $300,000 in Taxable Year 2015. Taxpayer D's total gross receipts for the four preceding taxable years are $4 million in a short taxable year beginning on August 1, 2012 and ending on December 31, 2012, $12 million in Taxable Year 2013, $14 million in Taxable Year 2014, and $10 million in Taxable Year 2015.

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 preceding taxable years:

   $100,000 + $200,000 + $300,000 = **$600,000**

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

   $12 million + $14 million + $10 million = **$36 million**

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

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

For purposes of determining Taxpayer D's Virginia base amount ONLY, its gross receipts for the short taxable year beginning on August 1, 2012 and ending on December 31, 2012 must be annualized as follows:

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

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 preceding taxable years:

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

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

1.67% x $11.4 million = **$190,380**

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

$190,380 or

50% x $250,000 = $125,000

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

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 - $190,380 = **$59,620**

b. The credit is equal to 15% of the lesser of $59,620 or $300,000:

   15% x $59,620 = **$8,943**

Computation of the Credit - Simplified Method

The procedure for computing the amount of the Research and Development Expenses Tax Credit using the simplified method is derived from the procedure for determining the federal alternative simplified credit for increasing research activities under IRC § 41(c)(5). For taxable years beginning on or after January 1, 2016, the simplified method for determining 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 Virginia qualified university expenses.

Step 3 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 4.

b. If the taxpayer did not pay or incur such expenses in any one of the three preceding taxable years, go to Step 7.

Step 4 From the amount of Virginia qualified research and development expenses determined in Step 1, subtract the amount computed in Step 3a.

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

b. If greater than zero and you have Virginia qualified university expenses, proceed to Step 5. If greater than zero and you do not have Virginia qualified university expenses, proceed to Step 6.

Step 5 Determine the amount of Virginia qualified university expenses in excess of 50 percent of the average amount of expenses for the three preceding taxable years.

a. Compute the percentage of expenses that are attributable to Virginia qualified university expenses by dividing the amount of Virginia qualified university expenses from Step 2 by the total amount of Virginia qualified research and development expenses from Step 1.

b. Multiply the percentage from Step 5a by the amount determined in Step 3a.

c. From the amount of Virginia qualified university expenses determined in Step 2, subtract the amount computed in Step 6b.

Step 6 If determined in Step 3a that the taxpayer paid or incurred Virginia qualified research and development expenses in each of the three preceding taxable years, compute the base credit as follows:

a. Multiply the amount determined in Step 4 by 10 percent.

b. Multiply the amount determined in Step 5 by 10 percent.

c. The base credit is the greater of:

- The lesser of the amount determined in Step 6a or $45,000; or
- The lesser of the amount determined in Step 6b or $60,000.

Step 7 If determined in Step 3b that the taxpayer did not pay or incur Virginia qualified research and development expenses in each of the three preceding taxable years, the base credit will be determined as follows:

a. Multiply the amount determined in Step 1 by 5 percent.

b. Multiply the amount determined in Step 2 by 5 percent.

c. The base credit is the greater of:

- The lesser of the amount determined in Step 7a or $45,000; or
- The lesser of the amount determined in Step 7b or $60,000.

Example 11: **Computation of the Credit, Part I**

Taxpayer E has $400,000 in Virginia qualified research and development expenses in Taxable Year 2016. Taxpayer E's Virginia qualified research and development expenses for the three preceding taxable years are: $400,000 in Taxable Year 2013, $200,000 in Taxable Year 2014, and $300,000 in Taxable Year 2015. Taxpayer E elected to utilize the simplified method for determining the credit.

Following Step 3a above, Taxpayer E 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%:

$400,000 + $200,000 + $300,000 = **$900,000**

$$\frac{\$900{,}000}{3} \times 50\% = \mathbf{\$150{,}000}$$

Following Step 4 above, subtract the amount determined in Step 3a from the Virginia qualified research and development expenses:

$400,000 - $150,000 = **$250,000**

Following Step 6 above, Taxpayer E may claim a credit equal to the lesser of:

10% of $250,000 or $45,000 = **$25,000**

Therefore, Taxpayer E's base credit for Taxable Year 2016 is **$25,000**.

Example 12: **Computation of Credit Amount for University Research, Part I**

Assume the same facts as in Example 11, except that $300,000 of Taxpayer E's $400,000 in Virginia qualified research and development expenses were Virginia qualified university expenses.

Following Step 5 above, the amount of Virginia qualified university expenses in excess of 50 percent of the average amount of expenses for the three preceding years is computed as follows:

a. Divide the Virginia qualified university expenses by the total amount of Virginia qualified research and development expenses:

$$\frac{\$300{,}000}{\$400{,}000} = \mathbf{75\%}$$

b. Multiply the percentage determined in Step 5a by the average amount of expenses determined in Step 3a:

75% x $150,000 = **$112,500**

c. Subtract the amount computed in Step 5b from the amount of Virginia qualified university expenses determined in Step 2:

$300,000 - $112,500 = **$187,500**

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

The lesser of 10% of $250,000 or $45,000 = **$25,000** or

The lesser of 10% of $187,500 or $60,000 = **$18,750**.

Therefore, Taxpayer E's base credit for Taxable Year 2016 is **$25,000**.

Example 13: **Computation of the Credit, Part II**

Taxpayer F has $2 million in Virginia qualified research and development expenses in Taxable Year 2016. Taxpayer F's Virginia qualified research and development expenses for the three preceding taxable years are: $0 in Taxable Year 2013, $500,000 in Taxable Year 2014, and $1.5 million in Taxable Year 2015. Taxpayer F elected to utilize the simplified method for determining the credit.

Because Taxpayer F did not pay or incur Virginia qualified research and development expenses in each of the three preceding taxable years, following Step 7 above, Taxpayer F may claim a base credit equal to the lesser of:

5% of $2 million or $45,000 = **$45,000**

Therefore, Taxpayer F's base credit for Taxable Year 2016 is **$45,000**.

Example 14: **Computation of Credit Amount for University Research, Part II**

Assume the same facts as in Example 13, except that $1 million of Taxpayer F's Virginia qualified research and development expenses were Virginia qualified university expenses. Following Step 7 above, Taxpayer F may claim a base credit equal to the greater of:

The lesser of 5% of $2 million or $45,000 = **$45,000** or

The lesser of 5% of $1 million or $60,000 = **$50,000**.

Therefore, Taxpayer F's base credit for Taxable Year 2016 is **$50,000**.

Example 15: **Computation of Supplemental Credit Amounts**

For Taxable Year 2016, the Department approved $6 million in base credits. Because the total amount of approved base credits was less than the $7 million credit cap for such taxable year, the Department will allocate supplemental credits of up to $1 million, on a pro rata basis, to taxpayers that are already approved for the base credit. Assume that, before proration, taxpayers are eligible for supplemental credits totaling $2 million for Taxable Year 2016.

When computing its Research and Development Expenses Tax Credit for Taxable Year 2016 using the simplified method for determining the credit, Taxpayer G was eligible for $80,000 in credits. However, such amount was subject to the $45,000 base credit cap. Therefore, Taxpayer G has $35,000 of excess credits that may be used toward the supplemental credit.

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

($1 million / $2 million) x $35,000 = **$17,500**

Therefore, Taxpayer G's supplemental credit for Taxable Year 2016 is $17,500. When Taxpayer G's $17,500 supplemental credit is combined with its $45,000 base credit, its total credit for Taxable Year 2016 is **$62,500**.

Example 16: **Proration of Base Credit Amounts**

Assume the same facts as in Example 15, except the Department receives $8 million in eligible base credit requests for Taxable Year 2016. Because the total amount of eligible base credit requests exceeds the $7 million credit cap for such taxable year, the base credit Taxpayer G may claim for Taxable Year 2016 must be proportionately reduced as follows:

($7 million / $8 million) x $45,000 = **$39,375**.

Because eligible base credit requests for Taxable Year 2016 exceeded the $7 million credit cap for such taxable year, taxpayers are ineligible for supplemental credits.

Short Taxable Year - Simplified Method

The method for computing the Research and Development Expenses Tax Credit when the credit year or any relevant preceding taxable year is a short taxable year for a taxpayer that has elected to utilize the simplified method for determining the credit 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.

If the credit year is a short taxable year, then the average amount of Virginia qualified research and development expenses for the three immediately preceding taxable years 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 immediately preceding taxable years 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).

Example 17: Credit Computation When Credit Year is a Short Taxable Year

Taxpayer H has $200,000 in Virginia qualified research and development expenses in a short taxable year beginning on January 1, 2017 and ending on September 30, 2017. Taxpayer H's Virginia qualified research and development expenses for the three preceding taxable years are: $150,000 in Taxable Year 2014, $200,000 in Taxable Year 2015, and $250,000 in Taxable Year 2016. Taxpayer H elected to utilize the simplified method for determining the credit.

Following Step 3a above, Taxpayer H 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%:

$\$150{,}000 + \$200{,}000 + \$250{,}000 = \mathbf{\$600{,}000}$

$$\frac{\$600{,}000}{3} \times 50\% = \mathbf{\$100{,}000}$$

Because the credit year is a short taxable year, Taxpayer H 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:

$100,000 x (273/365) = **$74,795**

Following Step 4 above, subtract the amount determined in Step 3a from the Virginia qualified research and development expenses:

$200,000 - $74,795 = **$125,205**

Following Step 6 above, Taxpayer H may claim a base credit equal to the lesser of:

10% of $125,205 or $45,000 = **$12,521**

Therefore, Taxpayer H's base credit for Taxable Year 2016 is **$12,521**.

Example 18: Credit Computation When Prior Year is a Short Taxable Year

Taxpayer J has $400,000 in Virginia qualified research and development expenses in Taxable Year 2016. Taxpayer J's Virginia qualified research and development expenses for the three preceding taxable years are: $80,000 in short taxable year beginning on October 1, 2013 and ending on December 31, 2013, $200,000 in Taxable Year 2014, and $300,000 in Taxable Year 2015. Taxpayer J elected to utilize the simplified method for determining the credit.

For purposes of determining the average amount of Virginia qualified research and development expenses Taxpayer J 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:

$$\frac{\$80{,}000 \text{ x } 365}{92} = \mathbf{\$317{,}391}$$

Following Step 3a above, Taxpayer J 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%:

$317,391 + $200,000 + $300,000 = **$817,391**

$$\frac{\$817{,}391}{3} \text{ x } 50\% = \mathbf{\$136{,}232}$$

Following Step 4 above, subtract the amount determined in Step 3a from the Virginia qualified research and development expenses:

$400,000 - $136,232 = **$263,768**

Following Step 6 above, Taxpayer J may claim a base credit equal to the lesser of:

10% of $263,768 or $45,000 = **$26,377**

Therefore, Taxpayer J's base credit for Taxable Year 2016 is **$26,377**.

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 determine 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 determine 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 in the year following the credit year. Effective beginning with applications due in 2020, the application deadline is September 1. The Department will review all applications for completeness and notify taxpayers of any errors by November 1. If any additional information is required, it must be provided to the Department no later than November 15 to be considered for the credit. All eligible taxpayers will then be notified 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). 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 computing its fixed-base percentage, a fiscal year filer utilizing the primary method for determining the credit must determine the amount of Virginia qualified research and development expenses and gross receipts it incurred during the three immediately preceding taxable years beginning with the taxable year ending in the calendar year immediately preceding the credit year. When computing its Virginia base amount, such fiscal year filer must determine the amount of gross receipts it incurred during the four immediately preceding taxable years, beginning with the taxable year ending in the calendar year immediately preceding the credit year.

A fiscal year filer utilizing the simplified method must determine the amount of Virginia qualified research and development expenses it incurred during the three immediately preceding taxable years beginning with the taxable year ending in the calendar year immediately preceding the credit year.

Example 19: Credit Computation for Fiscal Year Filers - Primary Method

Taxpayer K is a fiscal year filer with a taxable year that begins on July 1, and ends on June 30. Taxpayer K had $500,000 in Virginia qualified research and development expenses in Calendar Year 2016. Taxpayer K's Virginia qualified research and development expenses for the three preceding taxable years are: $300,000 in Taxable Year 2012; $250,000 in Taxable Year 2013; and $400,000 in Taxable Year 2014. Taxpayer K's total gross receipts for the four preceding taxable years are: $8 million in Taxable Year 2011, $6 million in Taxable Year 2012, $10 million in Taxable Year 2013, and $8 million in Taxable Year 2014.

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

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

   $300,000 + $250,000 + $400,000 = **$950,000**

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

   $6 million + $10 million + $8 million = **$24 million**

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

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

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

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

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

b. Multiply the fixed-base percentage determined by the average amount of gross receipts:

   3.96% x $8 million = **$316,800**

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

   $316,800 or

   50% x $500,000 = $250,000

   Taxpayer K's Virginia base amount is **$316,800**

Taxpayer K's base credit is computed as follows:

a. Subtract the Virginia base amount from the Virginia qualified research and development expenses for Calendar Year 2016:

   $500,000 - $316,800 = **$183,200**

b. The base credit is equal to 15% of the lesser of $183,200 or $300,000:

   15% x $183,200 = **$27,480**

Therefore, the credit amount that Taxpayer K may claim for Taxable Year 2015 is **$27,480**.

Example 20: Credit Computation for Fiscal Year Filers - Simplified Method

Taxpayer L is a fiscal year filer with a taxable year that begins on August 1, and ends on July 31. Taxpayer L had $300,000 in Virginia qualified research and development expenses in Calendar Year 2016. Taxpayer L's Virginia qualified research and development expenses for the three preceding taxable years are: $200,000 in Taxable Year 2012; $150,000 in Taxable Year 2013; and $100,000 in Taxable Year 2014. Taxpayer L elected to utilize the simplified method for determining the credit.

Taxpayer L 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%:

$200,000 + $150,000 + $100,000 = **$450,000**

$$\frac{\$450{,}000}{3} \times 50\% = \mathbf{\$75{,}000}$$

Taxpayer L must then subtract the average amount of the Virginia qualified research and development expenses it incurred for the three preceding taxable years from its Virginia qualified research and development expenses for Calendar Year 2016:

$300,000 - $75,000 = **$225,000**

Taxpayer L may claim a credit equal to the lesser of:

10% of $225,000 or $45,000 = **$22,500**

Therefore, the credit amount that Taxpayer L may claim for Taxable Year 2015 is **$22,500**.

Pass-Through Entities

A pass-through entity that is granted Research and Development Expenses Tax Credits is generally 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. A pass-through entity is permitted 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 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.

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A taxpayer that applies for credits 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.

The Department is required to 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.

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) 786-2992.

Approved:

Craig M. Burns
Tax Commissioner