Seven Pitfalls

It’s sometimes tricky to navigate through the mechanics of the R&D credit for small and mid-size companies that are R&D intensive. These companies don’t have a system in place to capture qualified research expenses and quantify them. Some assume they have to have laboratories on-site or registered patents to claim the credit. Among these companies, many that are organized as pass-through entities, fear the IRS will automatically audit the corporation’s and shareholders’ tax returns, once it finds out they are utilizing the credit.

Those companies who manage to brave through these myths, then face a host of pitfalls when it comes to passing-through the credit to their shareholders and carrying over unused credits for years to come. A wrong move or a simple oversight can cause loss or suspension of the credit, additional tax, and even penalties. The ever evolving landscape surrounding the R&D credit, makes using and defending it quite an undertaking for many companies, who decide to DIY and also those hiring R&D specialists. You want to make sure you know the pitfalls to avoid and pathways to take, so that your or your client’s hard-earned credit is properly claimed, retained, and put to use in the best way possible.

While this overview is focused on S-Corps, as they comprise most of the small to mid-size pass-through entities claiming the credits, these traps are not exclusive to S-Corps, and all pass-through entities face these obstacles in one way or another.
1. Pass through what, and to who

As a pass-through entity, an S-Corp generally doesn’t pay Federal income tax. Instead, it passes through its income, deductions, and credits to its shareholders who claim them on their K-1 schedules. The share of credit the S-Corp is entitled to, and that passed to shareholders is oftentimes a point of confusion.

California subjects all S-Corps to the franchise and income tax at a rate of 1.5%. Therefore, the California S-Corp tax may be offset by credit. The amount of credit allowed against the S-Corp’s tax of 1.5% is limited to 1/3 of the total credit amount calculated. This credit amount is also passed through on a pro-rata basis to the shareholders.

*Pitfall:* Shareholder’s election of credit reduction under section IRC section 280C(c) must be consistent with that of the S-Corp’s, although the actual credit reduction percentage may differ from that of the S-Corp’s. In some cases, the S-Corp may not even know what type of entity the shareholder is. Inconsistent election by the shareholder or wrong reduction percentage may be a reason for credit disallowance.

*Pathway:* Make sure shareholders always follow S-Corp’s election. In cases where shareholder’s entity is unknown, the S-Corp needs to report a pro-rata distributive amount of research credit on Schedule K-1 without IRC selection 280C(c) reduction, and note in the other information section of the schedule K-1 to reduce the credit by the shareholder’s applicable credit reduction percentage. Let’s look at 2 examples:

**Example 1:** XYZ S-Corp is owned 60% by John Smith and 40% by Lisa Green. The S-Corp generates $9,000 in credit and elects the reduced regular credit. John and Lisa must now also elect the reduced credit on their returns as follows:

- **S-Corp’s Credit:** $9,000 x 1/3 = $3,000
- **Reduced Credit:** $3,000 x 0.985 = $2,955
- **John’s Credit:** $9,000 x 0.6 = $5,400
- **Reduced Credit:** $5,400 x 0.877 = $4,736
- **Lisa’s Credit:** $9,000 x 0.4 = $3,600
- **Reduced Credit:** $3,600 x 0.877 = $3,157
Example 2: Partnership XY has 2 partners, C-Corporation and XYZ S-Corporation from Example 1, each owning 50%. The partnership generated $6,000 in credit, and elects the reduced credit, but is not sure which partner is the C-Corp and which is the S-corp. Therefore, the partnership reports the pro-rata amount of the research credit on Schedule K-1 of each of its partners. The credits are then calculated by each partner as follows:

C-Corp’s Credit: $6,000 x 50% x 0.9116 = $2,735

S-Corp’s Credit: $6,000 x 50% x 1/3 = $1,000
Reduced Credit: $1,000 x 0.985 = $985

As an S-Corp, XYZ will pass-through a pro-rata credit to its shareholders. Since the S-Corp elected the reduced credit, the shareholders must follow suit. Their credit will be:

John’s Credit: $6,000 x 50% x 0.6 x 0.877 = $1,579
Lisa’s Credit: $6,000 x 50% x 0.4 x 0.877 = $1,052

2. §41(g) Limitation

After spending resources to qualify costs and quantify the credit, shareholders may find out they are significantly limited when it comes to using it.

The amount of research credit passed through to shareholders’ schedule K-1 may be limited due to §41(g) and related regulations. This section limits the amount of tax attributed to a shareholder’s interest in the S-Corp that can be offset by a credit generated by this S-Corp.

Pitfall: Generally, if a shareholder has no taxable income from a particular business, the shareholder can’t claim research credit coming from this business to reduce taxable income coming from other sources.

Pathway: If §41(g) already put the brakes on that nice chuck of credit you thought you were going to get, worry not. You can always carry over to succeeding years any current and prior year pass-through research credit that exceeds §41(g) limitation until exhausted. The only problem is that these carryovers will still be subject to §41(g) limitation in subsequent years. To ensure maximum credit utilization, shareholders...
should try to “limit” the §41(g) limitation as much as possible. This can be achieved by breaking down to parameters the general §41(g) formula of Credit Limit:

\[
\text{Net Income Tax} - \text{Taxable Income attributable to interest in the S-Corp} - \text{Deduction of the taxpayer attributable to the interest in the S-Corp} + \text{Proportionate share of the deductions of the taxpayer not attributable to specific activity}
\]

And increasing or decreasing the dollar value of these parameters so that the limitation bar is raised and more credit is allowed to be utilized on the shareholder’s return.

<table>
<thead>
<tr>
<th>Formula Parameters</th>
<th>Direction</th>
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<tbody>
<tr>
<td>Net Income Tax (Fed Form- 1040 Lines 44 plus 45; CA Form- 540 Lines 35 plus 61)</td>
<td>↑</td>
</tr>
<tr>
<td>Deductions attributable to specific activities</td>
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<tr>
<td>Income (all types) from S-Corp including W-2 Wages</td>
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<tr>
<td>Income (all types) from other activities</td>
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<tr>
<td>Deductions attributable to interest in S-Corp</td>
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<tr>
<td>Proportionate share of deductions not attributable to specific activity</td>
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**3. Credit Assignment**

As mentioned, State Credits like the California Credit generated by an S-Corp may be used against the entity’s taxable state income. With the California program, any unused credit is carried over indefinitely to succeeding years until exhausted.

**Pitfall:** Research credit may be carried over indefinitely in CA, but when the company is dissolved, the credit is lost forever.

**Pathway:** A possible path to not losing the credit is provided to S-Corps or Partnerships which are part of a combined reporting group.
Under R&TC §23663, these entities can assign an eligible credit to any eligible assignee within a combined reporting group, who is then treated as if it originally generated the assigned credit. The assignment is irrevocable, must be made on assignor’s original return, and all restrictions and limitations, including carryover limitations that applied to the assignor, will also apply to the assignee.

Credit assignment is especially useful for a group in which one of the members is a startup generating a lot of credit but no revenue. If the startup’s growth model is not based on future monetization, these credits are doomed to be lost. To avoid that, another cash-hungry member of the group can be assigned and use these credits. Neither the assignor nor the assignee need to be engaged in R&D activities when the credit is actually utilized by the assignee.

4. Alternative Minimum Tax

Shareholders of S-Corps pay Fed and California income tax. As such, they are also subject to AMT. AMT represents the incremental portion of the tentative minimum tax (TMT) that exceeds the regular tax. If the regular tax exceeds the TMT, then no AMT exists.

_Pitfall:_ Many tax practitioners think that if their client is in an AMT position, there’s no point in calculating the R&D credit. In reality, this is not true.

_Pathway:_ If taxpayer owes AMT on their Federal return, it doesn’t necessarily mean they would owe AMT on their state return, and even if they do, some state R&D credit programs can still offset tax liability other than AMT. Tax practitioners should consider the potential for carryforwards, and the impact on state income tax when there is a State R&D Credit available. The key rules that cover most questions around the AMT limitations of R&D credit utilization are illustrated in the charts below.
a. For Federal tax purposes, R&D credit can’t offset tax liability below TMT, if the taxpayer owes AMT or not. If AMT is owed, R&D credit can’t offset it.

b. In some states, like CA, R&D credit can offset all tax liability, below TMT or above it, except for AMT.
5. Conversions

Corporate conversions have immediate ramifications on credits generated by the converting entity. These may render credits unusable or usable under limited circumstances. Before converting from one entity to another, these ramifications must be evaluated as, at times, the downside of losing the credits might outweigh the decision to convert the entity type.

**Pitfall:** Following the idea that when a Corporation converts from a C to an S Corp and vice versa, credits are lost forever both for the corporation and shareholders.

**Pathway:** Know what is lost and what is not in each situation on a corporate and individual level:

I. **Conversion from C-Corporation to S-Corporation**

    **Federal:** IRC § 1371(b)(1) doesn’t permit credit carryovers between C-Corporation and S-Corporation years, since credits generated in C-Corporation years are carried on the corporate return. If the corporate structure changes back to a C-Corporation, the credits can still be used, through time limits for carry forwards may apply. Once a C-Corporation that converted to an S-Corporation is sold, the suspended credits from the C-Corporation years can be used against built-in gains (BIG) tax, arising from the sale.

    - Shareholders: No portion of the C-Corporation tax year credits is allowed to pass through to the shareholders after C-Corporation is converted to an S-Corporation.

    **State Example:** California modified IRC rule to allow credit carryovers from C-Corporation to S-Corporation years, subject to the provision that credit carryovers from C-Corporation years are reduced to one-third for the first taxable year, but not the subsequent years. The remaining two-thirds credit is disregarded.

    - Shareholders: No portion of the C-Corporation tax year credits is allowed to pass through to the shareholders of the, now, S-Corporation.

II. **Conversion from S-Corporation to C-Corporation**

    **Federal:** IRC §1371(b) provides that if a corporation generates a credit during an S-Corporation year and later converts to a C-Corporation through termination of its S-
Safely Passing Through the R&D Credit

Corporation election, any unused credit can’t be used to reduce C-Corporation taxes after conversion, since essentially, all credits generated during the S-Corporation year are passed-through to the shareholders and carried over on their personal returns. For this reason, if the shareholders then decide to sell the C-Corp, those credits can’t be used to offset BIG tax, because this tax is calculated and paid on the corporate level.

- Shareholders of the S-Corp are entitled to recognize their credit after conversion from an S-Corp to a C-Corp, but they are still subject to the credit limitations under IRC §41(g).

State Example: California follows the IRC and makes no modifications to allow credits generated at the S-Corporation level to be carried over and used by a C-Corporation. However, if the C-Corporation makes a valid Federal and California S-Corporation election up to 5 years from the date of S-Corp termination, the credit could still be used at this time. This means that the S-Corp’s credit is not lost but suspended until the taxpayer becomes an S-Corporation again.

- Shareholders of the S-Corp are entitled to recognize the credit after conversion from an S-Corporation to a C-Corporation, but they are still subject to the credit limitations under IRC §41(g).

6. Passive Activity Credit

When a shareholder is engaged in different activities, some of his activities may be characterized as passive and others, as non-passive. Credits that arise from passive activities can only offset the tax attributable to the passive income.

Pitfall: If a shareholder of an S-Corporation doesn’t materially participate in the activities generating the credit, the research credit allocable to the shareholder is considered a passive activity credit. Using this credit to offset a shareholder’s tax attributable to activities in which he materially participated, could result in disallowance of the credit.

Pathway: A shareholder is materially participating in an activity only if the shareholder is involved in the operations of the activity on a basis which is regular, continuous, and substantial. If not, then the activity is considered passive and credit generated by this
activity is passive credit. Passive activity credit can be carried forward to future years to be used against passive income. If the passive activities, i.e., research and development activities, are disposed of, the credit is lost completely. However, under §469, if the shareholder’s tax liability is great enough to use the suspended credits in the final year of the activity, then the passive credits are treated as regular tax credits and subject to the same limits as other general business credits.

7. Closed Years

For many companies, and especially startups, R&D costs are incurred in years, when no revenue is generated. The company then reports a net operating loss (NOL) on its tax returns and carry it forward up to 20 years. While NOL can shield the company from prospective taxes, it’s only good as long as it lasts. By the time the NOL carryforward runs out, the statute of limitation for prior years, in which R&D costs surged, ran as well. In S-Corps and other pass-through entities, this issue is even more frustrating, since the entity’s returns are filed before the shareholders returns, so while shareholders’ returns are still open, they can use no credit from the entity, since entity’s SOL has long expired. At this point, shareholders are lead to believe they are out of luck and the credits they have foregone in prior years are now lost forever.

_Pitfall:_ The IRS manual states that a credit must have been claimed on an original return or on a timely filed amended return before a carryback or carryover can be honored, regardless if the credit could have been used in the credit year. Following this clear rule- closed year, no opportunity- would mean leaving valuable credits on the table.

_Pathway:_ Several court cases and rulings made it clear that a closed year can still be “amended”. The underlying theory is that although the statute of limitations has run on the originating year, the proper calculation of the credit carryover from that year is still “open” to the extent the credit is being used to offset tax in an open year. Since there is no ability to amend a closed year, you can either attach a statement to an open year’s return explaining the adjustment to the credit carryforward and NOL carryforward, if any, on the entity’s return. These same adjustments can be subsequently made on the shareholders returns, allowing them to carryforward and use the credits in open years.
Conclusions

Small and midsize companies comprise many the claimants for R&D credits. These businesses are predominantly pass-through entities organized as S-Corps. S-Corp’s shareholders and other pass-through members claim the research credit on their individual tax returns, while C-Corporations capture and claim the credit on their corporate returns. The pitfalls of passing through, utilizing, and carrying over the credit abound, and many defer to their tax advisers for good advice. Understanding the rules and limitations surrounding these pitfalls, makes it easier to navigate between these obstacles to successfully utilize the credit on the entity level, and safely drive it to the shareholders.
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More information can be found at www.taxcreditco.com.