Tax Impact

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Tax Tips

The R&D credit: Are you leaving tax dollars on the table?

Federal and state research credits (often referred to as the "research and development," "R&D" or "research and experimentation" credit) are among the most valuable tax incentives available today. But many businesses overlook these tax breaks because they mistakenly believe that they don't qualify or wouldn't benefit. In recent years, federal legislation has expanded the availability of the credit for many businesses. So, if your business hasn't been claiming the R&D credit, it's worth another look.

What's it worth to you?

To claim the federal R&D credit, simply conducting research isn't enough; it's for "increasing research activities." Generally, it's equal to 20% of the amount by which qualified research expenditures (QREs) in a tax year exceed a base amount derived from your company's historical R&D expenditures. There are alternative computation methods for start-ups and other companies without sufficient historical data.

Calculating the credit is complex, but qualifying companies can reduce their federal income tax liability by as much as 13.5 cents for every dollar they spend on QREs. This includes wages, supplies, and certain consulting and contract research fees related to qualified research activities. The credit is nonrefundable — that is, it can't be used to generate a loss — but unused credits may be carried back one year or forward up to 20 years. In addition, limits on general business credits prevent companies from using tax credits to erase their tax liability entirely. Many states offer tax credits in addition to those available at the federal level, so be sure to consider those benefits.

Are you eligible?

The R&D credit isn't just for scientific research. In brief, qualifying research must relate to development or improvement of a business component with an uncertain probability of success, involve activities that are technological in nature, and use a process of experimentation. These criteria are broad enough to encompass a wide range of business activities, including developing new products, improving processes (including business or financial processes that involve computer technology) or developing software for internal use.

What's changed?

Two recent tax law changes expanded the availability of the R&D credit and enhanced its benefits: The Protecting Americans from Tax Hikes (PATH) Act of 2015 and the Tax Cuts and Jobs Act (TCJA). The PATH act, in

The end of expensing R&D?

As you evaluate the tax implications of your research spending, keep in mind that, under the Tax Cuts and Jobs Act, most research and development expenditures incurred in tax years beginning after 2021 must be capitalized and amortized over at least five years (15 years for research conducted outside the United States). Currently, businesses have the option of amortizing these expenditures or deducting them as current expenses. This change will affect not only the deductibility of R&D expenses, but also the value of the reduced R&D credit.

Some commentators believe that Congress will modify or eliminate this provision before it takes effect, so be sure to keep abreast of future developments. If the provision is maintained, it'll be important for you to incorporate it into your tax planning.

addition to making the R&D credit permanent, made it available to start-up businesses that hadn't been able to take advantage of the credit because they had insufficient federal tax liability.

In general, businesses in operation for less than five years, with less than $5 million in gross receipts, may use R&D credits to reduce up to $250,000 in employer-paid payroll taxes.

The TCJA didn't make any direct changes to the R&D credit, but several of its changes have a significant, indirect impact on the credit. For example, by eliminating the corporate alternative minimum tax (AMT) and increasing exemption amounts for individual AMT, the TCJA made the credit available to many businesses that otherwise wouldn't be able to use it. That's because the credit may not be offset against AMT (with an exception for certain smaller businesses). The TCJA removed this obstacle for businesses no longer exposed to AMT.

The TCJA also affected the R&D credit by reducing the corporate income tax rate from a top rate of 35% to a flat 21% rate. This enhances the value of the credit for pass-through businesses — such as partnerships, S corporations and LLCs — that elect a reduced credit. To avoid a double tax benefit, the tax code prohibits businesses that claim R&D credits from also deducting those amounts as a business expense. But businesses have the option of preserving those deductions by electing to reduce their credits by the maximum corporate tax rate.

For most C corporations, the election is a wash — it has no impact on their federal tax liability. But it may allow them to reduce their state income tax liability. For pass-through owners, however, who are taxed at individual rates as high as 37%, the election may offer significant benefits. Why? Because, by making the election, an owner in the top tax bracket trades a 21% reduction in the credit for deductions that reduce his or her tax liability on the same amount by 37%. Note that another change made by the TCJA will reduce the benefits of R&D deductions starting in 2022. (See "The end of expensing R&D?" above.)

Revisit the credit

If your business engages in research activities but hasn't been claiming the R&D credit, now's a good time to revisit it to see if recent changes affect your eligibility. You may have an opportunity to reduce your federal and state tax liability on future returns and even claim credits you missed during certain prior years by filing amended returns. ■

5 good reasons to turn down an inheritance

You may use a qualified disclaimer to refuse a bequest from a loved one. Doing so will cause an asset to bypass your estate and go to the next beneficiary in line. What are the reasons you'd take this action? Let's take a closer look at five reasons:

1. Gift and estate tax savings. This is often cited as the main incentive for using a qualified disclaimer. For starters, the unlimited marital deduction shelters all transfers between spouses from gift and estate tax. In addition, transfers to nonspouse beneficiaries, such as your children and grandchildren, may be covered by the gift and estate tax exemption.

Currently, the exemption can shelter a generous $11.4 million in assets for 2019. By maximizing portability of any unused exemption amount, a married couple can effectively pass up to $22.8 million in 2019 to their heirs free of gift and estate taxes.

A disclaimer may be used as a means for passing a family-owned business to the younger generation.

However, despite these lofty amounts, wealthier individuals, including those who aren't married and can't benefit from the unlimited marital deduction or portability, still might have estate tax liability concerns. By using a disclaimer, you ensure that the exemption won't be further eroded by the inherited amount. Assuming you don't need the money, shifting the funds to the younger generation without it ever touching

your hands can save gift and estate tax for the family as a whole.

2. Generation-skipping transfer (GST) tax. Disclaimers may also be useful in planning for the GST tax. This tax applies to most transfers that skip a generation, such as bequests and gifts from a grandparent to a grandchild or comparable transfers through trusts. Like the gift and estate tax exemption, the GST tax exemption is $11.4 million for 2019.

If GST tax liability is a concern, you may wish to disclaim an inheritance. For instance, if you disclaim a parent's assets, the parent's exemption can shelter the transfer from the GST tax when the inheritance goes directly to your children. The GST tax exemption for your own assets won't be affected.

3. Family businesses. A disclaimer may also be used as a means for passing a family-owned business to the younger generation. By disclaiming an interest in the business, you can position stock ownership to your family's benefit.

4. Creditor protection. Any inheritance you receive would immediately be subject to creditors' claims. It might be possible to avoid dire results by using

a disclaimer to protect these assets. However, state laws and federal bankruptcy laws may defeat or hinder this goal. Consult with your estate planning advisor about your specific situation.

5. Charitable deductions. In some cases, a charitable contribution may be structured to provide a life estate, with the remainder going to a charitable organization. Without the benefit of a charitable remainder trust, an estate won't qualify for a charitable deduction in this instance, but using a disclaimer can provide a deduction because the assets will pass directly to the charity.

Before you make a final decision on whether to accept a bequest or use a qualified disclaimer to refuse it, discuss it with your estate planning advisor. ■

When it comes to taxes, getting married may cost you

Most people don't choose to marry or stay single based on their tax bills, but it may be a factor. One byproduct of the U.S. tax system, under which married couples file joint tax returns, is that marriage may produce a tax penalty or bonus, depending on a couple's particular circumstances. In other words, when couples marry, their tax liability may be more or less than their individual tax liabilities combined.

Congress has attempted to reduce some of the disparity by tweaking the tax brackets and making other changes, but it's virtually impossible to eliminate marriage penalties or bonuses in every situation. In fact, other countries avoid the issue by taxing a married couple as two individuals.

Examples

The tax consequences of marriage depend on a variety of factors, so it's difficult to make any generalizations about the tax costs or windfalls of tying the knot. Here are some examples that illustrate the potential issues.

Often, couples enjoy a marriage bonus when one spouse is the primary income earner. On the other hand, it's common for spouses whose incomes are comparable to pay more tax than they did as two individuals. Let's suppose that two couples, Will and Grace and Ross and Rachel, each have total wages of $400,000. Neither couple has children and neither itemizes deductions. Will and Grace earn $80,000 and $320,000 respectively, while Ross and Rachel earn $200,000 each. According to the Tax Policy Center's Marriage Calculator, Will and Grace will save nearly $11,000 in taxes by getting married, while Ross and Rachel will pay $1 more.

Now assume that each of the four individuals has one child under the age of 13 and pays $10,000 in mortgage interest and $10,000 in state and local taxes. Under this scenario, Will and Grace would still save more than $7,000 in taxes, but Ross and Rachel's taxes would go up by more than $6,000.

These are just hypothetical estimates that disregard many other factors that affect a couple's tax liability, but the examples demonstrate that under certain circumstances the marriage penalty or bonus can be significant.

Penalties built into the tax code

Certain provisions of the tax code contain their own penalties on marriage. For example, the Tax Cuts and Jobs Act (TCJA) imposes a $10,000 limit on itemized deductions for state and local taxes. The limit is the same for joint filers and individuals. That means unmarried partners can deduct $10,000 each, for a total of $20,000, while married couples can deduct only $10,000.

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There's a similar marriage penalty on mortgage interest deductions. The TCJA reduced the amount of home acquisition debt that's eligible for interest deductions from $1 million to $750,000. Again, the limit is the same for joint filers and individuals, so while married couples can deduct interest on only $750,000 in home acquisition debt, unmarried partners can deduct interest on up to a combined $1.5 million.

Do the math

If you're getting married, it's a good idea to crunch the numbers and see how your union will affect your tax bill. No one would suggest that a potential marriage penalty or bonus should influence your decision to tie the knot, but knowing the impact can help you and your partner make informed financial planning decisions. ■

Because you believe in second chances

If this isn't your first trip down the aisle, you and your spouse-to-be likely bring more — including financial assets and, possibly, children — to the marriage. To protect everyone's interests and start your journey together on the right foot:

1. Review all assets and liabilities. Should you combine accounts and property or maintain separate ownership? If one spouse has significant debt (or child support payments), how will you manage it as a couple?

2. Update paperwork. Change insurance and retirement account beneficiary designations. Also revise your will or estate plan.

3. Consider a trust. A QTIP trust can help provide for your current spouse *and* for children from a previous marriage.

4. Make tax plans. Will you file joint or separate tax returns? How will you handle other tax issues?

5. Get professional advice. We can help you with tax and financial matters. You should also consult an attorney because marriage laws vary widely by state.

Case highlights state taxation of trust income

In a recent case, the U.S. Supreme Court ruled that the presence of trust beneficiaries in North Carolina did not, by itself, empower the state to tax income earned by an out-of-state trust. The court noted that the trust didn't have a physical presence, make any direct investments or hold any real property in North Carolina. Moreover, the in-state beneficiaries had no right to demand trust income and it was uncertain whether such income would be distributed to them. Under these circumstances, the beneficiaries' in-state residence was too tenuous a link between the state and the trust to support imposition of its income tax.

In light of this ruling, trusts currently filing income tax returns in a state solely because of the presence of one or more beneficiaries living there should reconsider whether such filings are required. ■

Consider forgiving intrafamily loans

The federal gift and estate tax exemption is at its highest level ever — $11.4 million. But this generous tax break is only temporary. In 2026 — or sooner if lawmakers so decide — it'll drop back to its previous level of $5 million (indexed for inflation). One way to take advantage of the higher exemption before it expires is to forgive loans to your children or other family members. These loans are often used in connection with estate planning techniques that enable you to transfer wealth tax-free, but their success often depends on whether returns on the loan proceeds exceed certain thresholds. Outright gifts — including forgiveness of an outstanding loan — may be a more reliable way to transfer wealth, so long as you have enough unused exemption to shield it from gift taxes. ■

Employee bonuses: Deduct now, pay later

If your business is on the accrual basis of accounting, you may be able to deduct year-end employee bonuses this year even if you don't pay them until next year. And your employees need not report these bonuses as income until they file their 2020 tax returns.

To take advantage of this year-end tax planning technique, you must pay bonuses within 2½ months after the end of the tax year (by March 15 for calendar-year businesses) and meet certain other requirements. Among other things, you can't accelerate deductions on bonuses paid to related parties, including certain company owners or shareholders, and the bonuses must be "fixed and determinable" as of the last day of this year. ■

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