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Tax Reconciliation Bills Would Extend and Modify Research Credit

Though the section 41 research tax credit expired on December 31, 2005, the Senate and House have both passed separate tax reconciliation bills that, among other things, would extend and enhance the research tax credit. The differences between H.R. 4297, the Tax Relief Extension Reconciliation Act of 2005 and the Senate-passed tax reconciliation bill (S. 2020, Tax Relief Act of 2005) have yet to be reconciled in conference. Given that the legislative calendar for January will be dominated by the confirmation hearings for Judge Alito, it is possible that the bills will not be reconciled until late January or February.

Enacted in 1981, the research tax credit is an incentive for performing research to develop a new or improved product or manufacturing process. Since then it has been amended and extended a number of times, most recently in 2004. Factoring in section 280C, the credit is currently worth 13 cents for every \$1 of incremental qualified wages and supplies, and 9 cents for every \$1 of incremental qualified contract research payments, subject to certain conditions and assumptions. For pharmaceutical companies that make large investments in R&D, changes to the calculation of, or requirements for claiming, the credit can significantly impact their tax strategy.

Both H.R. 4297 and S. 2020 would extend the research credit through December 31, 2006. The Senate bill would be effective for taxable years ending after December 31, 2005 and the House Ways and Means bill would be effective for taxable years ending after the date of enactment. Both bills include three key provisions:

- Allow taxpayers to elect an alternative simplified credit (ASC) for qualified research expenses (QRE). The ASC would equal 12 percent of the QRE for taxable years that exceed 50 percent of the average QRE for the three taxable years preceding the credit determination year. If the taxpayer has no QRE in any one of the three preceding tax years, the rate of the ASC would equal six percent of the QRE for the credit determination year. An ASC election applies to the taxable year for which it is made and for all succeeding taxable years unless revoked with the consent of the IRS.
- Increase the rates of the alternative incremental credit (AIRC) for each of the three steps, i.e., first step increased to three percent from 2.65 percent; second step increased to four percent from 3.2 percent; and third step increased to five percent from 3.75 percent.
- Coordinate the ASC and AIRC so that a taxpayer could not claim both of them.

Clearly, the key change introduced in both bills is the ASC. Although the ASC promises a greatly simplified method for calculating the credit based on past QREs, companies weighing the benefit of the ASC against the standard credit and the AIRC should perform the calculations under all three methodologies and also



consider their history of sustaining the QREs claimed . Companies would be well advised to consider these issues carefully, since the ASC election, as currently proposed, is binding.

Successfully Claiming the R&D Credit

The key to a sustainable R&D credit is accurately documenting the credit year activities and costs, the base period activities and costs, qualifying your activities, and quantifying activities from an accounting perspective. Knowing your industry positions with the IRS and staying informed about current issues can help you to anticipate and prepare for questions before they are raised. Also consider your state credits; over 30 states offer tax credits related to R&D activities, and the state tax benefits may be greater than the federal benefits. However, the credit benefits and calculations vary from state to state, and companies should weigh the relative value of the state credits against each other.

Finally, you should prepare your audit strategy and be proactive with the IRS. Assess your risk in light of the IRS-issued audit guidelines specific to the pharmaceutical industry, and if necessary work with the IRS to establish guidelines that will help facilitate compliance and administration when substantiating research credits.

Please note that the changes to the research tax credit discussed above have not yet been enacted. The research tax credit provisions contained in H.R. 4297 and S. 2020 are subject to change as the legislative process continues.



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