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In this article, Abbey and Swanick consider instances in which the section 280C(c) election for a research credit may be disadvantageous because of the base erosion and antiabuse tax.

The section 280C(c) election provides for a reduced research credit as determined under section 41 and is often made for state tax purposes. Taxpayers typically, but not always, made this election before the Tax Cuts and Jobs Act. However, given the preferential place that the research credit has in the base erosion and antiabuse tax calculation, this election may not always be advantageous, even considering state tax implications. This article illustrates some examples of when the election may not make sense.

I. Background

A. Section 280C(c) Election

Section 280C(c)(1) provides that if a taxpayer claims a research credit under section 41, a portion of qualified or basic research expenses¹ are not deductible. The nondeductible amount equals the amount of the credit. As an alternative, however, taxpayers can elect to reduce their research credit.² The new credit is calculated as the original research credit less the original research credit times the maximum tax rate (21 percent) under section 11(b).

For example, assume a company has a research credit of \$2 million. Under the general rule, \$2 million of deductible research expenses (equal to the research credit) are added back to taxable income. If the taxpayer makes an election for a reduced credit, the new credit is computed as \$2 million minus \$420,000 (21 percent of \$2 million), or \$1.58 million, and no expenses are added back to taxable income.

In most cases, federal tax liability is the same. For example, let's assume that the taxpayer has \$20 million of taxable income. Without the election, the \$20 million becomes \$22 million. Tax liability is \$4.62 million reduced by the research credit of \$2 million, resulting in \$2.62 million.

With the election, the taxpayer has \$20 million of taxable income and tax of \$4.2 million. The research credit is \$1.58 million, resulting in \$2.62 million of tax liability.

The purpose of section 280C(c) in general is to avoid the double benefit of a credit and a deduction. Since the tax liability is the same, why

¹ As defined in section 41(b) and (e)(2).

² Section 280C(c)(3).

then do most taxpayers make the election? Certainly, the overall tax posture of the taxpayer and other relevant attributes may make a taxpayer lean one way versus another. Historically, a company's alternative minimum tax and section 199 profiles played a part.

However, the main reason to make the election has been the state tax effect. Some states do not provide for a research credit but use federal taxable income as a starting point in determining their tax base (for example, North Carolina), or they calculate the research credit differently (for example, California). The election, therefore, was often the status quo choice in calculating the federal research credit.

B. The BEAT

The BEAT is a minimum tax that applies to "applicable taxpayers," as defined in section 59A(e). An applicable taxpayer is a corporation³ that has average annual gross receipts of at least \$500 million⁴ for the previous three tax years and has a base erosion percentage in excess of 3 percent. The base erosion percentage for a tax year is the base erosion tax benefits divided by the sum of the deductions allowable to the taxpayer, plus the base erosion tax benefits.⁵ A base erosion tax benefit is generally a deductible base erosion payment.⁶ Base erosion payments are any amount paid or accrued to a related foreign person, as determined in section 59A(g).

After this definitional word salad is navigated, the taxpayer must determine if there is a minimum tax due. Specifically, the BEAT minimum tax amount (BEMTA) is the excess of 10 percent of the modified taxable income (MTI) over regular tax liability, reduced by tax credits to the extent total tax credits exceed the sum of the research credit plus the lesser of 80 percent of section 38 credits or the BEMTA.⁷ MTI is regular taxable income increased by the base erosion tax

benefits, or the base erosion percentage of a net operating loss deduction.⁸ In essence, the BEMTA calculation can be expressed as:

$$\text{BEMTA} = 10 \text{ percent} * \text{MTI} - \text{regular tax liability} - (\text{tax credits} - (\text{research credit}^9 + \text{lesser of 80 percent section 38 credits or BEMTA}))$$

This is a circuitous path to get to the punchline: The research credit is beneficial in a BEAT calculation. Unfortunately, the intersection of several tax provisions can nullify this benefit. The general business credit, of which the research credit is a part, is essentially limited to the amount of tax liability,¹⁰ making it nonrefundable. In determining this tax liability, it is necessary to consider the hierarchy of tax credits, in which case the foreign tax credit takes precedent over the general business credit.¹¹ Accordingly, if a taxpayer has FTCs in a given year, the research credit will be reduced, possibly to zero. Lest taxpayers think that this hierarchy is ignored in the alternate BEAT universe, the preamble to the 2018 proposed BEAT regulations (REG-104259-18), which was also adopted in the final regulations (T.D. 9885), makes it clear that for purposes of BEAT, the same rule applies — that is, if regular tax liability is reduced to zero before the research credit, there is no BEMTA benefit for the research credit in that year. Given the dichotomy between the FTC and research credits when it comes to regular tax versus BEAT, careful consideration should be given in evaluating a section 280C election.

II. Examples

In the following examples, assume that taxable income is \$50 million, the research credit is \$3 million without the election and \$2.37 million with the election, and the taxpayer has base erosion payments of \$8 million. The taxable income limitation in section 38(c) does not limit the amount of the research credit.

³Excluding S corporations, real estate investment trusts, and regulated investment companies.

⁴The \$500 million is itself determined using aggregation rules as determined under section 52. See section 59A(e)(3).

⁵Section 59A(c)(4)(A). As with all things, certain items are excluded. See section 59A(c)(4)(B).

⁶See section 59A(c)(2).

⁷Section 59A(b).

⁸Section 59A(c)(1).

⁹This favorable provision no longer applies for tax years starting after December 31, 2025. See section 59A(b)(2)(B).

¹⁰See section 38(c)(1).

¹¹See *id.* (flush language).

A. Example 1

In this example, the taxpayer has a \$7 million FTC. Without the election, \$3 million of research expenses must be added back to taxable income.

Table 1. Example 1

280C Election		No 280C Election	
Taxable income	\$5 million	Taxable income	\$53 million
Tax	\$10.5 million	Tax	\$11.13 million
FTC	(\$7 million)	FTC	(\$7 million)
Research credit	(\$2.37 million)	Research credit	(\$3 million)
Net tax	\$1.13 million	Net tax	\$1.13 million
Taxable income	\$50 million	Taxable income	\$53 million
Base erosion payments	\$8 million	Base erosion payments	\$8 million
MTI	\$58 million	MTI	\$61 million
BEMTA ^a	\$2.3 million	BEMTA ^b	\$1.97 million
State tax ^c	\$3.5 million	State tax	\$3.71 million
Total	\$6.93 million	Total	\$6.81 million
^a BEMTA = \$58 million * 10 percent - \$10.5 million - (\$9.37 million - (\$2.37 million + 0)). ^b BEMTA = \$61 million * 10 percent - \$11.13 million - (\$10 million - (\$3 million + 0)). ^c Assumes 7 percent state rate for each of the examples.			

In Example 1, the taxpayer is better off *not* making the section 280C(c) election. Given the high FTC available and the reduction to the research credit in the section 280C(c) election scenario, the BEMTA and state tax combined produce an unfavorable result. Without the election, though, the taxpayer achieves the result of increasing taxable income that is offset by additional research credit with no change to regular tax liability. However, this increased research credit reduces the BEMTA, producing a net benefit even when the higher state tax is considered.

As with most things in tax, the above is not a universal rule and at some point, not making the election goes against the taxpayer.

B. Example 2

Example 2 is the same as Example 1, except the FTC is \$4.75 million rather than \$7 million.

Table 2. Example 2

280C Election		No 280C Election	
Taxable income	\$50 million	Taxable income	\$53 million
Tax	\$10.5 million	Tax	\$11.13 million
FTC	(\$4.75 million)	FTC	(\$4.75 million)
Research credit	(\$2.37 million)	Research credit	(\$3 million)
Net tax	\$3.38 million	Net tax	\$3.38 million
Taxable income	\$50 million	Taxable income	\$53 million
Base erosion payments	\$8 million	Base erosion payments	\$8 million
MTI	\$58 million	MTI	\$61 million
BEMTA ^a	\$50,000	BEMTA ^b	—
State tax	\$3.5 million	State tax	\$3.71 million
Total	\$6.93 million	Total	\$7.09 million
^a BEMTA = \$58 million * 10 percent - \$10.5 million - (\$7.12 million - (\$2.37 million + 0)). ^b BEMTA = \$61 million * 10 percent - \$11.13 million - (\$7.75 million - (\$3 million + 0)).			

While federal tax liability is \$3.38 million with or without the election and BEMTA drops in this scenario, the state tax increase because of the increase in federal taxable income is greater than the reduction in BEMTA. The taxpayer break-even point depends on numerous factors not captured by these simplified examples, including, for instance, any limitation to the research credit through section 38(c), and the state effective tax rate. Modeling is necessary to test for the point.

Another scenario to consider is the outcome of not making the election if the base erosion payments consist of contract research, a realistic possibility.

C. Example 3

Example 3 is the same as Example 1. However, the \$8 million of base erosion payments consist of \$3 million for research services.

Table 3. Example 3

280C Election		No 280C Election	
Taxable income	\$50 million	Taxable income	\$53 million
Tax	\$10.5 million	Tax	\$11.13 million
FTC	(\$7 million)	FTC	(\$7 million)
Research credit	(\$2.37 million)	Research credit	(\$3 million)
Net tax	\$1.13 million	Net tax	\$1.13 million
Taxable income	\$50 million	Taxable income	\$53 million
Research expenses	\$3 million	Research expenses	—
Shared services	\$5 million	Shared services	\$5 million
MTI	\$58 million	MTI	\$58 million
BEMTA ^a	\$2.3 million	BEMTA ^b	\$1.67 million
State tax	\$3.5 million	State tax	\$3.71 million
Total	\$6.93 million	Total	\$6.51 million

^aBEMTA = \$58 million * 10 percent - \$10.5 million - (\$9.37 million - (\$2.37 million + 0)).

^bBEMTA = \$61 million * 10 percent - \$11.13 million - (\$10 million - (\$3 million + 0)).

Because the research expense is no longer deductible, it no longer provides a base erosion tax benefit and is excluded from the BEAT calculation. The result is certainly taxpayer-favorable, at least in the simplified example above. Further, it may pose an alternative to the first-tier foreign research center branch, which comes with a laundry list of other issues, as a BEAT mitigation option.

III. Conclusion

For BEAT taxpayers, the section 280C(c) election may not make sense in all cases. Whether eschewing the election provides a tax benefit can turn on the smallest of margins because there are several variables at play (for example, state tax profile and section 38(c) limitations). The election is one of the many tax items post-TCJA that needs to be dusted off and reconsidered. Taxpayers should sharpen their pencils and run the numbers. ■

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