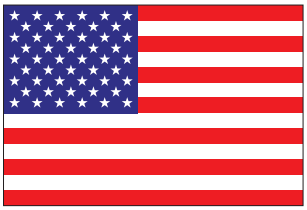
United States



Regulations providing important interpretative guidance were issued during 2014 and 2015 in the United States.

Background

Federal corporate taxable income is subject to graduated tax rates, ranging from 15% to 35%. Most states also impose an income tax with rates ranging from 4.6%–12%. The average combined federal/state corporate tax rate is 39.1%.

The US offers a nonrefundable research tax credit. Forty-five states offer a research tax credit that is similar to the federal tax credit, but at a lower credit rate. There are, however, a few states that offer refundable credits.

Nature of incentives

Taxpayers can elect to report an Alternative Simplified Credit or a Traditional Research Tax Credit:

Traditional research tax credit (20%): The "traditional credit" is equal to 20% of the amount of the qualified research expenses (QREs) exceeding a "base amount." The base amount is computed by: (i) first determining the ratio of qualified research expenses (QREs) to gross receipts for the period of 1984–1988. This ratio is called the fixed base percentage and reflects the amount of gross receipts a company has historically committed to R&D. There is a special start-up company rule that applies in determining the fixed base percentage if the company was not around during the base period (1984 – 1988). The fixed base percentage is then multiplied by the average gross receipts of the taxpayer for the four years preceding the credit year. The product of this calculation is the base amount, i.e., reflecting the amount of gross receipts a company would expect to commit to qualified research. The base amount must be adjusted for acquisitions and dispositions. This can be challenging considering that records dating back to the early 1980s are often not readily available.

Alternative Simplified Credit (14%): The alternative simplified credit (ASC) is equal to 14% of the excess of the QREs over 50% of the average of the previous three years' QREs. The ASC base amount is therefore much easier to determine than under the traditional method and most taxpayers elect the ASC.

- There also are special credits for basic research (i.e., research with no commercial objective), payments to energy research consortium, and research relating to orphan drugs (providing a credit equal to 50% of the amount spent on clinical research).

Computational adjustments: There are several computational adjustments that significantly reduce the true value of these R&D tax credits.

- While qualifying R&D expenses are currently deductible, taxpayers must reduce the current deduction by the amount of the tax credit. Alternatively, taxpayers can elect to report the traditional credit at 13% or the ASC at 9.1%. This election must be made annually on a timely filed original income tax return.
- There is a minimum base amount applicable only to the traditional credit equal to 50% QREs. The cumulative effect of limiting deductions (or electing a reduced credit rate of 13%) and the minimum base amount, is that the maximum value of the traditional credit is 6.5% QREs.
- There is no minimum base amount for the alternative simplified credit. If, however, there is no qualified research spending in any one of the previous three years, the credit is equal to 6% of qualified research spending in the current tax period.
- The cumulative effect of limiting deductions (or electing a reduced credit rate of 9.1%) for the ASC and the base calculation rules, is that the maximum value of the ASC is less than 9.1% of current qualified R&D spending. If qualified research spending is consistent year-over-year, then the maximum value of the ASC is about 5% of qualified R&D spending.
- The US offers tax credits to offset current, prior, and future income tax liability. Unused research credits can be carried back one year and carried forward 20 years. While there is no cap on the amount of credits that can be utilized, certain general business credit limitations apply.

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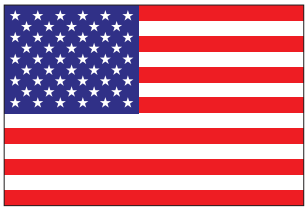

Interpretive guidance was issued by the government during 2014 and 2015 to resolve several issues:

Supply Regulations: The government issued final regulations in July of 2014 regarding the treatment of prototype supplies used in research. The regulations provide that the costs incurred to construct a "pilot model" are qualified research expenses. A "pilot model" is any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product. The term includes a fully-functional representation or model of the product or a component of a product.

The regulations further provide that it is irrelevant whether R&D results in a product that is ultimately sold or used in the taxpayer's trade or business. Consequently, the cost of supplies used to construct a pilot model for design testing generally will qualify as a QRE even if the research is successful and the product developed through the R&D is ultimately sold or the production equipment is placed in service.

The regulations illustrate the application of the new rules with several examples. One example concerns the cost to develop an experimental airplane, concluding that the entire cost to construct the airplane is a qualified research expense because the airplane was constructed to test whether the airplane satisfied the taxpayer's design requirements.

The new supply regulations generally will apply to the taxpayer's current tax year and the preceding three years.

Internal Use Software Proposed Regulations: Prior to the issuance of these proposed regulations in January of 2015, the legal standard for qualifying internal-use software was unclear. Expenses incurred for developing software that was primarily for internal use could qualify for the research credit only if it was highly innovative. The proposed regulations define software developed primarily for internal use to include only software developed to perform G&A functions. Importantly, the proposed regulations provide that software is not developed primarily for internal use if "[t]he software is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system." Examples of this type of software, as noted in the proposed regulations, includes: "software developed for third parties to execute banking transactions, track the progress of a delivery of goods, search a taxpayer's inventory for goods, store and retrieve a third party's digital files, purchase tickets for transportation or entertainment, and receive services over the internet."

The Preamble to the proposed regulations specifies that this new guidance is intended to expand the opportunities for taxpayers to claim research credits for software-related expenses.

While the regulations have been proposed, but not finalized, the government will allow taxpayers to rely on the positions expressed in the proposed regulations for any tax year ending on or after 20 January 2015.

Eligible industries and qualifying costs

The incentive is intended to benefit all industries conducting qualified research. Consequently, all industries are eligible for the research credit.

Qualifying costs include: wages for in-house labor, 65% of contract research, and supplies used in the research process. Overhead and capital expenditure are excluded.

IP and jurisdictional restrictions

There is no restriction on the location of any resulting IP. Qualifying activities must be performed within the US and the related qualifying costs must be incurred by a US taxpayer (although such costs may be reimbursed by a foreign affiliate).

Other concerns

Taxpayers may amend prior year returns to claim tax credits if the tax year is open for assessment of tax (generally the three prior tax years). Prior to 2015, the ASC had to be elected on a timely filed original return. However, final regulations issued in February 2015 provide that the ASC now may be claimed on amended returns as long as no research credit was reported for the tax year that is being amended. This new rule can generally be applied to the three tax years preceding the current tax year.

While the US offers pre-filing agreements to resolve whether taxpayers are entitled to research credits prior to the filing of the return, such agreements are rarely used.

United States

Nature of benefit available	Income tax benefit generally available	Specific pre-approval required from government	Refundable/ Carryforward
Tax credits	Incremental research tax credits	No	Unused credits may be carried back one year and forward 20 years.

R&D activities must occur in country	Cap/Limitations on benefits	IP must be retained in country	Industry eligibility restriction
Yes	No	No	No