

State of Connecticut Research and Development Tax Credits

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The State of Connecticut has enacted a number of tax provisions designed to encourage research and development activities within its borders. Of principal significance are the tax credit allowances under the corporate business tax regime. There are three tax credit provisions: the basic tax credit, the incremental tax credit for certain increases in expenditures from year to year and the credit for certain incremental increases in grants to institutions of higher learning for conducting research and development.

In order to qualify for the various credits, an expenditure must (i) either be deductible under the provisions of Section 174 of the Internal Revenue Code of 1986, as amended (the "Code"), or creditable under Section 41 of the Code and (ii) be incurred for research and experimentation and basic research conducted in Connecticut and (iii) not be funded by a person other than the taxpayer. Qualifying expenditures may include, but are not limited to, expenditures incurred in the taxpayer's trade or business that represent research and development costs in the experimental or laboratory sense, all costs incident to the development or improvement of a product, including any pilot model, process, formula, invention, technique, patent or similar property, and costs of obtaining a patent, such as attorneys' fees expended in connection therewith. Not included are overhead and other expenses of a gen-

eral administrative nature that relate to the corporation's activities as a whole and do not contribute directly to the research and development effort.

Each credit is subject to a different set of computational rules, and it is not possible to use a particular expenditure for more than one credit. The amount of the basic credit is dependent upon the size of the taxpayer (expressed for the most part by reference to its gross income for the year in question) and the amount of the expenditure. Credits which are allowed but exceed the applicable limitation amounts can be carried forward to successive years until used. For taxable years beginning or after January 1, 2000, "qualified small businesses", defined as corporations with income in the previous year that did not exceed \$70 million, are entitled to exchange any unused credits for the year for a refund equal to 65% of the amount of the credit rather than carrying it forward.

The credit for incremental increases in research and development expenditures is equal to 20% of the excess of research and experimental expenditures in Connecticut in the current income year over such expenditures in the preceding income year. Unused credits may be carried forward for 15 years until they are used. Like the basic research credit, unused incremental research and development

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credits of qualifying small businesses can be exchanged for a tax refund equal to 65% of the amount of the credit.

The credit for grants to institutions of higher education located in Connecticut is equal to 25% of the amount of grants made to a qualifying institution in the taxpayer's current income year that exceed the average qualifying grants made during the preceding three income years. No carry-forward or carryback of any unused credit is allowed, and there is no provision for a refund as in the case of the other two credits.

A few points should be made about the various research and development tax credits. First of all, unlike a deduction which only reduces income subject to tax, they are available as a dollar-for-dollar offset against a taxpayer's Connecticut corporation business tax liability.

Second, in making a decision regarding whether to monetize a credit, a taxpayer must make a judgment regarding the timing of its future profitability. If it is likely that the taxpayer will be paying business corporation

taxes within several years of the year in which expenditures qualifying for the credit are incurred, it will probably be better off not electing to monetize the credits at the 65% discount rate.

Third, there is a limitation on how much a taxpayer can recover in any particular year under the tax credit monetization program. Under this limitation, which became effective July 1, 2002, any taxpayer that is entitled to a research and development tax refund attributable to income years 2000 and 2001 that has not received its payment before July 1, 2002 will only be entitled to receive \$1 million in any state fiscal year with the balance being payable in equal installments over the succeeding two state fiscal years. For refund claims attributable to income years beginning after January 1, 2002, the limitation applicable to any state fiscal year is \$1.5 million.

Fourth, with the exception of the credit for grants to institutions of higher education, expenditures cannot be funded by someone other than the taxpayer and still qualify for the credit unless the taxpayer is entitled to retain the results of the research. As a result,

if a corporation conducts contract research for another person, the corporation conducting the research will not be entitled to include the associated expenditures in computing the amount of its credit.

Fifth, the research and development must be conducted in Connecticut to qualify for the credit. So, for example, even though a corporation might be incorporated in Connecticut or subject to tax here, it will not be entitled to include any expenditures associated with out-of-state research in calculating its credit. By the same token, a taxpayer that is not subject to Connecticut taxation can establish a subsidiary that is subject to tax here and claim a credit for qualifying expenditures by the subsidiary.

If you should have a question regarding the Connecticut research and development tax credits, please contact Bruce Hood at 212.551.2604 or bhood@wiggin.com or Peter Gruen at 203.498.4357 or pgruen@wiggin.com.

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