



FYI Income 22

Research and Development Income Tax Credit for Enterprise Zones

Taxpayers who make expenditures on research and experimental activities in an enterprise zone qualify for an income tax credit. The 3% credit is based on the increase of a company's research and experimental expenditures within an enterprise zone over the average of such expenditures conducted in the same enterprise zone during the previous **two** income tax years. The expenditures must meet the research and experimental activities as defined in section 174 of the federal Internal Revenue Code of 1986, as amended. [§39-30-105.5, C.R.S.]

PRECERTIFYING THE CREDIT

For any credit generated on or after January 1, 2012, most enterprise zone credits must be precertified by the zone administrator prior to any business activity that would generate the enterprise zone credit. This includes the investment tax credit, commercial vehicle investment tax credit, new business facility jobs credits, research and development credit, qualified job training credit, and rehabilitation of vacant commercial buildings credit. [§39-30-103(7), C.R.S.]

Precertification must be applied for online at www.advancecolorado.com/ez or by submitting the DR 0074, DR 0076 or DR 0077 certification forms to the zone administrator. Precertification is effective from the date approved/signed by the zone administrator until the close of the tax year indicated in the application. Any credit not precertified cannot be claimed on a tax return.

CRITERIA

Qualified research must satisfy three criteria:

- It must be technological in nature.
- It must be useful in the development of a new or improved product or component of the business.
- It must utilize the process of experimentation.

In-house research expenses may include:

- Wages, excluding fringe benefits.
- Supplies.
- Payments for the right to use computers.

Contract research expenses may include the amount paid for research done by a third-party for the benefit of the contracting firm.

The following types of expenses **do not** qualify:

- Land or improvements to land.
- Depreciable equipment.
- Management surveys.
- Costs incurred to adapt a product to a particular customer's needs.
- Research funded by any government entity.

HOW TO CALCULATE THE CREDIT

The total amount of the calculated credit must be divided equally over four years. The taxpayer may claim 25% of the tax credit in the year the expenditure is made and 25% in each of the following three years.

The taxpayer must submit a certification from the Enterprise Zone Administrator (DR 0077) showing that the business is located in an enterprise zone.

Example: During 2010, the Smith Company spent \$325,000 for research in an enterprise zone. During 2009, the company spent \$200,000 on research in the same enterprise zone. During 2008, the company spent \$100,000 in research in the same enterprise zone. The company's 2010 research and experimental income tax credit is computed as follows:

2010 enterprise zone research expenditures	\$325,000
2009 enterprise zone research expenditures	\$200,000
2008 enterprise zone research expenditures	\$100,000
Total 2008 and 2009	\$300,000
Average of 2008 and 2009	\$150,000
Qualifying expenditures (\$325,000 - \$150,000)	\$175,000
Allowable credit at 3%	\$5,250
Credit allowed in 2010 (25% of credit)	\$1,313
Credit allowed in 2011 (25% of credit)	\$1,313
Credit allowed in 2012 (25% of credit)	\$1,313
Credit allowed in 2013 (25% of credit)	\$1,313

If the Smith Company's 2011 research expenditures in the enterprise zone were the same or less than the average of the 2009 and 2010 expenditures, there would be no additional tax credit for 2011. However, if the company's 2011 research expenditures increased, the credit would be computed in this way:

2011 enterprise zone research expenditures	\$600,000
2010 enterprise zone research expenditures	\$325,000
2009 enterprise zone research expenditures	\$200,000
Total 2009 and 2010	\$525,000
Average of 2009 and 2010	\$262,500
Qualifying expenditures (\$600,000 - \$262,500)	\$337,500
Allowable credit at 3%	\$10,125
Credit allowed in 2011 (25% of credit)	\$2,531
Credit allowed in 2012 (25% of credit)	\$2,531
Credit allowed in 2013 (25% of credit)	\$2,531
Credit allowed in 2014 (25% of credit)	\$2,531

Since the Smith Company is still carrying the 2010 credit forward, the total 2011 credit would be calculated as follows:

2010 research expenditure credit	\$1,313
2011 expenditure credit	<u>+\$2,531</u>
2011 total income tax credit	\$3,844

If the taxpayer's tax liability is less than the research and experimental credit, the remaining amount may be carried forward to the subsequent tax years. There is no limit on the number of years this credit can be carried forward.

Example: The Smith Company's 2011 tax liability is \$3,000. This is less than the company's total 2011 research credit of \$3,844. Therefore, the Smith Company may carry forward the \$844 to the 2012 tax return.

CLAIMING THE CREDIT

Electronic Certification Process

The enterprise zone certification is now available online at www.advancecolorado.com/ez and taxpayers are encouraged to use this new system, which is more accurate and secure than the paper certification process. This online system will be used for both the precertification process and the final certification of the tax credits.

Electronic Notification

For tax years beginning on or after January 1, 2012, the Office of Economic Development and International Trade (OEDIT) will electronically notify the Department of Revenue of any credits generated in 2012 or later. Enterprise Zone credits cannot be claimed on a tax return filed prior to this notification. The Department of Revenue will post notification on its Web site in the Income Tax Index when the information is available and returns can be filed to claim these credits, which should occur no later than March 31.

The department strongly recommends that taxpayers use the online certification process to ensure that the credit data is accurately and timely transmitted to the Department of Revenue. This is particularly important for pass-through entities that must provide the name, ID number and the amount of the distributed credit of each partner/shareholder/member of the entity. Failure to accurately provide this information will result in the tax credit being denied until the information is corrected with the Enterprise Zone administrator.

Electronic Filing

For any tax year beginning on or after January 1, 2012, any Colorado original or amended income tax return that claims an enterprise zone credit must be filed electronically. The return must also include a carryforward schedule (form to be developed during 2012) for all enterprise zone credits.

Taxpayers who are unable to file electronically can file a paper return. However, the department strongly encourages taxpayers to file electronically to avoid unnecessary delays and problems that can occur when taxpayers file a paper return for these complex credits and schedules.

COMMON QUESTIONS

How is the average research and experimental expenditures amount computed for the last two years when a company had no such expense in one or both of those years?

If there was no research and experimental expenditures in one or both of the previous two income tax years, then the average expenditure should be computed using zero for that year(s).

Does the federal limitation of 65% of contract research expenses apply to the enterprise zone research and development credit?

No. The Colorado statute refers only to section 174 of the federal code for determining qualified expenditures.

How is the credit computed if the taxpayer moves from one enterprise zone to another?

The credit is computed by comparing expenses in a particular enterprise zone as compared to expenses from the prior two years in the same zone. If the company moves to a different zone, then the computation of the credit starts over by comparing qualified expenses to the prior two years' expenses within the new enterprise zone.

Must third-party research be performed within an enterprise zone?

Yes.

More information is available through the Colorado Office of Economic Development & International Trade (OEDIT) located at 1625 Broadway, Room 2700, Denver, CO 80202; Telephone is (303) 892-3840. You may also visit the OEDIT Web site at www.advancecolorado.com/ez for more information on Colorado Enterprise Zones.

FYIs provide general information concerning a variety of Colorado tax topics in simple and straightforward language. Although the FYIs represent a good faith effort to provide accurate and complete tax information, the information is not binding on the Colorado Department of Revenue, nor does it replace, alter, or supersede Colorado law and regulations. The Executive Director, who by statute is the only person having the authority to bind the Department, has not formally reviewed and/or approved these FYIs.