



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.]

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 2005, the Smith Company spent \$325,000 for research in an enterprise zone. During 2004, the company spent \$200,000 on research in the same enterprise zone. During 2003, the company spent \$100,000 in research in the same enterprise zone. The company's 2005 research and experimental income tax credit is computed as follows:

2005 enterprise zone research expenditures	\$325,000
2004 enterprise zone research expenditures	\$200,000
2003 enterprise zone research expenditures	\$100,000
Total 2003 and 2004	\$300,000
Average of 2003 and 2004	\$150,000
Qualifying expenditures (\$325,000 - \$150,000)	\$175,000
Allowable credit at 3%	\$5,250
Credit allowed in 2005 (25% of credit)	\$1,313
Credit allowed in 2006 (25% of credit)	\$1,313
Credit allowed in 2007 (25% of credit)	\$1,313
Credit allowed in 2008 (25% of credit)	\$1,313

If the Smith Company's 2006 research expenditures in the enterprise zone were the same or less than the average of the 2004 and 2005 expenditures, there would be no additional tax credit for 2006. However, if the company's 2006 research expenditures increased, the credit would be computed in this way:

2006 enterprise zone research expenditures	\$600,000
2005 enterprise zone research expenditures	\$325,000
2004 enterprise zone research expenditures	\$200,000
Total 2004 and 2005	\$525,000
Average of 2004 and 2005	\$262,500
Qualifying expenditures (\$600,000 - \$262,500)	\$337,500
Allowable credit at 3%	\$10,125
Credit allowed in 2006 (25% of credit)	\$2,531
Credit allowed in 2007 (25% of credit)	\$2,531
Credit allowed in 2008 (25% of credit)	\$2,531
Credit allowed in 2009 (25% of credit)	\$2,531

Since the Smith Company is still carrying the 2005 credit forward, the total 2006 credit would be calculated as follows:

2005 research expenditure credit	\$1,313
2006 expenditure credit	<u>+\$2,531</u>
2006 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 2006 tax liability is \$3,000. This is less than the company's total 2006 research credit of \$3,844. Therefore, the Smith Company may carry forward the \$844 to the 2007 tax return.

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/enterprisezone for more information on Colorado Enterprise Zones.

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