

State of Rhode Island - Division of Taxation

Tax Credits/Deductions

Regulation CR 95-06

Research and Development Property Credit

I. GENERAL

A credit is available to corporations, sole proprietors or passed through from partnerships, joint ventures or subchapter S corporations for research and development property acquired, constructed, reconstructed or erected after July 1, 1994. The credit is 10% of the cost or other basis of realty and tangible personalty which is depreciable; has a useful life of 3 years or more; was acquired by purchase; has a situs in Rhode Island and is used principally for purposes of research and development in the experimental or laboratory sense.

II. DEFINITIONS

A. "Research and development in the experimental or laboratory sense" shall not be deemed to include the ordinary testing or inspection of materials or products for quality control, efficiency surveys, management studies, consumer surveys, advertising, promotions, or research in connection with literary, historical or similar projects.

B. "Structural components" means such separately attached parts of a building, as walls and built-in partitions, permanent paneling and tiling, doors, stairways, the entire central heating, plumbing, electrical, and air conditioning systems. Sink and toilet facilities, sprinkler systems, fire escapes, elevators and escalators do not qualify. For the purpose of this regulation, the building and all of its structural components are treated as a whole when the building is acquired, constructed, reconstructed or erected and first placed in service. The repairs, alterations, improvements or replacement of a structural component subsequent to the acquisition, construction, reconstruction or erection of the building will not be allowed the credit.

C. " Principally used" means used more than 50%. A building or addition is principally used in research and development in the experimental or laboratory sense where more than 50% of its usable business floor space is thusly used.

Floor space used for bathrooms, cafeterias and lounges is not usable business floor space. Machinery is principally used in research and development in the experimental or laboratory sense when it is thusly used more than 50% of its normal operating time.

III. RATE

The credit is ten percent (10%) of the cost or other basis for federal income tax purposes of tangible personal property, and other tangible property, including buildings and structural components of buildings acquired, constructed or reconstructed, or erected after July 1, 1994.

IV. BASIC TESTS

In order to qualify for this credit, the tangible personal property and other tangible property, including buildings and structural components of buildings must meet all of the following tests and therefore must:

- A. be depreciable pursuant to section 167 of the Internal Revenue Code or recovery property with respect to which a deduction is allowable under section 168 of the Internal Revenue Code;
- B. have a useful life of three (3) years or more;
- C. be acquired by purchase as defined in section 179(d) of the Internal Revenue Code;
- D. have a situs in this state; and
- E. be used principally for purposes of research and development in the experimental or laboratory sense.

V. LEASED/RENTED PROPERTY

A. Partially leased/rented to others: Generally, a taxpayer is not allowed a credit for realty or tangible personalty including buildings and structural components of buildings which it leases or rents to any other person or corporation. However, if real property (buildings) is principally used by the taxpayer in research and development and is partially rented or leased or leased to others, the basis of the property must be adjusted for that proportionate share of nonqualifying use.

EXAMPLES: RST corporation, a calendar year corporation, acquires a five story building (with each story of equal square footage) on October 1, 1994. The basis of the building is \$200,000.

1. The taxpayer rents or leases out three floors and uses the remaining two floors for research and development in the experimental or laboratory sense. Since less than 50% of the building is used for research and development in the experimental or laboratory sense, no credit is allowed on any part of the building.
2. The taxpayer rents or leases out two floors and uses the remaining three floors for research and development in the experimental or laboratory sense. Since more than 50% of the building is used for research and development in the experimental or laboratory sense, credit will be allowed on that part of the building which is not leased.
3. The taxpayer does not rent/lease any of the building; uses three floors for research and development in the experimental or laboratory sense; and uses the other two floors for office space. Since more than 50% of the building is used for research and development in the experimental or laboratory sense and none is leased, credit will be allowed on the entire building.

B. Leased/rented from any other person or corporation: A taxpayer is not allowed a credit for realty or tangible personalty including buildings and structural components of buildings which it leases from any other person or corporation. Any contract or agreement to lease or rent or for a license to use the property shall be considered a lease unless such contract or agreement is treated for federal income tax purposes as an installment purchase rather than as a lease. In order to be considered the owner of the research and development property, the taxpayer must be allowed federal depreciation on such property.

C. User of the property: Since property rented to others (rather than principally used by the taxpayer in research and development) does not qualify for the credit, the credit shall not be allowed where the purchaser is not the user of the research and development property even where the purchaser and the user may be included in a consolidated federal and/or consolidated state tax return.

VI. TIMING

A. Property is considered first placed in service by the taxpayer in the tax year in which under the taxpayer's depreciation practice, the period for depreciation for the property begins or the year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function, whichever is earlier.

B. Only the amounts actually paid by the taxpayer for qualifying property after July 1, 1994 qualify for the credit.

C. Acquisitions in a taxable year do not affect similar property previously qualifying. For example, a taxpayer builds an addition to a previously qualifying building for use as office space. The investment in the addition will not qualify for the credit since it is not used for research and development in the experimental or laboratory sense but it will not trigger a recapture of the credit taken on the previously existing structure. If the addition were built for and used principally in research and development in the experimental or laboratory sense (and the other criteria for the credit were satisfied), the credit would apply to the addition.

VII. LIMITATIONS, CARRYOVERS AND MISCELLANEOUS

A. No deduction for research and development facilities under section 44-32-1 shall be allowed for research and development property for which the credit is allowed under these provisions.

B. No investment tax credit under section 44-31-1 shall be allowed for research and development property for which the credit is allowed under these provisions.

C. Consolidated returns: The credit allowed for research and development property for which the credit is claimed under these provisions shall only be allowed against the tax of that corporation included in a consolidated return that qualifies for the credit and not against the tax of other corporations that may join in the filing of a consolidated return.

D. Division of the credit: In the event that the taxpayer is a partnership, joint venture or small business corporation, the credit shall be divided in the same manner as income.

E. Order of credits: The investment tax credit allowed by section 44-31-1 shall be used by the taxpayer before the credit claimed under these provisions.

F. Minimum tax and carryover: In the case of corporations, the credit for research and development property allowed shall not reduce the tax due to less than the minimum fixed by section 44-11-2 (e). However, any amount of credit not used in such taxable year may be carried over to the following year or years, up to a maximum of seven (7) years, and may be credited against the taxpayer's tax for such year or years. For purposes of chapter 44-30, if the credit allowed exceeds the taxpayer's tax for such year, the amount of credit not used in such taxable

year may be carried over to the following year or years, up to a maximum of seven (7) years, and may be credited against the taxpayer's tax for such year or years.

VIII. RECAPTURE

In general, a recapture of a portion of the credit is required where the property on which a credit has been allowed is disposed of or ceases to be in qualified use.

The following are examples of some types of incidents which require recapture of the credit (this list is not all-inclusive):

1. A legal dissolution;
2. A trade in;
3. Foreclosure of a security interest;
4. Retirement before expiration of its useful life;
5. Destruction or damage by fire, storm or other casualty or by reason of its theft or other involuntary conversion;
6. Where property is leased to others;
7. Removal of property from this state;
8. Cease to own property;
9. Cease to be in qualified use.

Generally, recapture is computed:

$$e = \frac{\text{Recapture Tax credit taken on property ceasing to qualify}}{\text{(Useful life in months - qualified use in month)}} \times$$

(useful life of property in months)

The following rules apply to transactions between taxpayers:

A. A recapture of this credit is required unless all of the following elements are present in the transaction:

1. The property is transferred from one taxpayer to another by a transaction in which the basis of the property in the hands of the transferee is determined in whole or in part by reference to the basis in the hands of the transferor, or a mere change in the form of the taxpayer's business; and
2. the acquiring taxpayer is taxable under Chapters 44-11 or 44-30 of the Rhode Island General Laws; and
3. the property continues to be in qualified use.

If all of the preceding elements are present in the transaction, the transfer will not require a recapture of the credit and any unused credit on the transferred property may be passed through to and carried forward by the acquiring taxpayer.

If the property in the hands of the acquiring taxpayer is not in qualifying use for its entire life or for the period of time outlined in the recapture provisions below, a recapture by the acquiring taxpayer is required. In measuring the period of qualified use, the period during which the property was held by the transferor taxpayer and the acquiring taxpayer shall be taken into account.

The above rules do not strictly conform to federal treatment. For example, a recapture is required where a transfer is made other than to an acquiring taxpayer taxable under Chapters 44-11 or 44-30 (on the theory that the property is no longer in qualified use).

B. Recapture of Section 167 property:

1. In the year initially claimed: If property depreciable under section 167 of the Internal Revenue Code is disposed of or ceases to be in qualified use prior to the end of the taxable year in which the credit is to be taken, the amount of the credit shall be that portion of the credit provided for in this section which represents the ratio which the months of qualified use bear to the months of useful life.

2. In subsequent years: If property on which credit has been taken is disposed of or ceases to be in qualified use prior to the end of its useful life, the difference between the credit taken and the credit allowed for actual use must be added back in the year of disposition.

3. After 12 consecutive years: If qualifying property is disposed of or ceases to be in qualified use after it has been in qualified use for more than twelve (12) consecutive years, it shall not be necessary to recapture any remaining credit as provided in this subparagraph. The amount of credit allowed for actual use shall be determined by multiplying the original credit by the ratio which the months of qualified use bear to the months of useful life. For purposes of this subparagraph, useful life of property shall be the same as the taxpayer uses for depreciation purposes when computing the federal income tax liability.

C. Recapture of Section 168, 3 year property: This type of recapture applies to three (3) year property, as defined in paragraph two (2) of section (c) of section 168 of the Internal Revenue Code, other than that type of property included in the recapture of buildings and structural components of buildings (VIII D. below).

1. In the year initially claimed: If the property is disposed of or ceases to be in qualified use prior to the end of the taxable year in which the credit is to be taken, the amount of the credit shall be that portion of the credit which represents the ratio which the months of qualified use bear to thirty-six.

2. In subsequent years: If property on which credit has been taken is disposed of or ceases to be in qualified use prior to the end of thirty-six (36) months, the difference between the credit taken and the credit allowed for actual use must be added back in the year of disposition. The amount of credit allowed for actual use shall be determined by multiplying the original credit by the ratio which the months of qualified use bear to thirty-six (36).

D. Recapture of Section 168 property: This section deals with recapture and any recovery property which is a building or a structural component of a building to which section 168 of the Internal Revenue Code applies.

1. In the year initially claimed: If qualifying property which is a building or a structural component of a building is disposed of or ceases to be in qualified use prior to the end of the taxable year in which the credit is to be taken, the amount of the credit shall be that portion of the credit provided for in this section which represents the ratio which the months of qualified use bear to the total number of months over which the taxpayer chooses to deduct the property under section 168 of the Internal Revenue Code.

2. In subsequent years: If property on which credit has been taken is disposed of or ceases to be in qualified use prior to the end of the period over which the taxpayer chooses to deduct the property under section 168 of the Internal Revenue Code, the difference between the credit taken and the credit allowed for actual use must be added back in the year of disposition.

3. After 12 consecutive years: If such property is disposed of or ceases to be in qualified use after it has been in qualified use for more than twelve (12) consecutive years, it shall not be necessary to add back the credit as provided in this subparagraph. The amount of credit allowed for actual use shall be determined by multiplying the original credit by the ratio which the months of qualified use bear to the total number of months over which the taxpayer chooses to deduct the property under section 168 of the Internal Revenue Code.

E. Where property is disposed of or ceases to be in qualified use during other than the initial taxable year, the taxpayer may not reduce the amount of tax liability created by a recapture of this credit by credits of this type allowed for the year in which the asset is disposed of, nor can that liability be reduced by any carryovers of this credit to that year. The amount of recapture must be added to the taxpayer's tax in that year.

IX. FEDERAL REFERENCES

For the purpose of determining the basis of qualifying property, the carryover of credit and of the recapture of the credit, pertinent portions of the Internal Revenue Code and regulations thereunder, including provisions applicable to corporations, Subchapter S corporations, estates and trusts, and partnerships are deemed adopted to the extent not inconsistent with this regulation and Rhode Island law.

R. GARY CLARK TAX ADMINISTRATOR

EFFECTIVE DATE: JANUARY 1, 1995