

2004 Credit for Increased Research Expenses - Individuals

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General Instructions

ARS §§ 43-1074.01 provides a nonrefundable individual income tax credit for increased research activities in a taxable year. The credit for increased research activities applies to taxable years beginning January 1, 2001 and later.

The Arizona tax credit for individuals is allowed in an amount computed pursuant to IRC § 41 with the following exceptions:

- Qualified research includes only research conducted in Arizona. The term "qualified research," for purposes of the Arizona tax credit, means qualified research, as defined in IRC § 41, that is conducted in Arizona.
- The amount of the credit is based on the federal regular credit computation method for Arizona qualified research expenses. [Taxpayers CANNOT use the federal alternative credit computation method.] The allowable current taxable year credit is a percentage of the excess, if any, of the Arizona qualified research expenses for the taxable year over the base amount.

If the allowable expenses do not exceed \$2,500,000, the allowable credit is 20 percent of this amount. If the allowable expenses exceed \$2,500,000, the allowable credit amount is \$500,000 plus 11 percent of the amount of expenses over \$2,500,000, subject to certain limitations. The allowable credit limitation is the *lesser* of the amount computed above, or: (a) \$1,500,000 (for taxable years beginning January 1, 2001 through December 31, 2001) or (b) \$2,500,000 (for taxable years beginning January 1, 2002 through December 31, 2002).

- If two or more taxpayers, including shareholders of an S corporation and partners in a partnership, share in the eligible expenses, each taxpayer is eligible to receive a proportionate share of the credit.
- The termination provisions of IRC § 41 do not apply.

CARRYOVER OF UNUSED CREDIT

If the current taxable year credit exceeds the taxpayer's tax liability for the taxable year, the taxpayer may carry forward the unused credit to the next 15 consecutive taxable years.

LIMITATION ON USE OF CARRYOVERS FROM TAXABLE YEARS BEGINNING JANUARY 1, 2001 THROUGH DECEMBER 31, 2002: The amount of the credit carryover that may be used in any taxable year is the LESSER OF: (a) the tax liability, or (b) \$500,000, MINUS (c) the current year credit for increased research activities (regardless of the amount of the current year credit that is claimed on the tax return). [If the current year credit is \$500,000 or more, the taxpayer cannot use the credit carryover in that taxable year.

LIMITATION ON USE OF CARRYOVERS FROM TAXABLE YEARS BEGINNING JANUARY 1, 2003 AND LATER: The amount of credit carryover that may be used in any taxable year is limited to the amount by which the tax liability exceeds the current year credit for increased research activities.

DOES A TAXPAYER HAVE TO MAKE OTHER ADJUSTMENTS TO ARIZONA GROSS INCOME OR TO THE ARIZONA TAX CREDIT FOR INCREASED RESEARCH ACTIVITIES?

- Arizona statutes do not require an addition to Arizona gross income for the amount of qualified research expenses equal to the amount of the allowable Arizona credit for increased research expenses for the taxable year.
- If the taxpayer reduces the amount of the deduction for qualified research expenses in the computation of federal adjusted gross income, Arizona statutes do not allow a subtraction from Arizona gross income for the amount of the expense reduction.
- If the taxpayer adjusts the federal asset basis of capitalized research expenses and reduces the amount of amortization deductible in the computation of federal adjusted gross income, Arizona statutes do not allow a subtraction from Arizona gross income for additional amortization.
- If the taxpayer claims a reduced federal credit for increased research expenses and claims the Arizona credit for increased research expenses, Arizona statutes do not require the taxpayer to reduce the Arizona credit for increased research expenses in a manner similar to the federal reduction method.

Specific Instructions

Complete the name and taxpayer identification number section at the top of the form. Indicate the period covered by the taxable year (in an MM/DD/YYYY format). Attach the completed form to the tax return.

All returns, statements, and other documents filed with the department require a taxpayer identification number (TIN). The TIN for an individual is the taxpayer's social security number or an IRS individual taxpayer identification number. Taxpayers that fail to include their TIN may be subject to a penalty.

Part I - Current Taxable Year Credit Calculation (Sole Proprietorships Only)

NOTE: Complete this part only if the individual operates a business as a sole proprietorship and the sole proprietorship incurred qualified research expenses during the taxable year.

Line 1 -

Enter total wages paid or incurred for qualified services performed in Arizona. Do not include the amount of such wages paid to employees that were used in the calculation of the federal work opportunity credit. Wages include any wages paid or incurred to an employee for qualified services performed by such employee. Qualified services consist of engaging in qualified research or engaging in the direct supervision or direct support of research activities which constitute qualified research.

Line 2 -

Enter the cost of supplies paid or incurred for use in the conduct of qualified research in Arizona. Supplies include expenditures for any tangible property other than land or improvements to land, and property of a character subject to the allowance for depreciation.

Line 3 -

Enter the amount paid or incurred to rent or lease the right to use computers in the conduct of qualified research in Arizona.

Line 4 -

Enter the total of:

- (a) Seventy-five percent (.75) of any amount paid or incurred for qualified research performed in Arizona by a qualified research consortium on the taxpayer's behalf. "Qualified research consortium" is any qualifying organization as defined in IRC § 41(b)(3)(C)(ii).
- (b) Sixty-five percent (.65) of any amount paid or incurred for qualified research performed in Arizona on the taxpayer's behalf, other than such amounts paid to a qualified research consortium. Prepaid contract research expenses are considered paid in the year the research is actually done.

Line 6 -

Enter the average annual Arizona gross receipts for the four taxable years preceding the taxable year for which the credit is being determined (the credit year). The taxpayer may be required to annualize gross receipts for any short taxable year.

Line 7 -

Round off the percentage to the nearest one, one hundredth of one percent (four decimal places). Compute the fixed-base percentage as follows:

- **Existing firms** - An existing firm is one that had both Arizona gross receipts and Arizona qualified research expenses for at least three taxable years beginning after December 31, 1983, and before January 1, 1989. The

fixed-base percentage is the ratio that the aggregate Arizona qualified research expenses for all taxable years beginning after 1983, and before 1989, bears to the aggregate Arizona gross receipts for such taxable years.

- **Start-up companies** - A start-up company is one that had both Arizona gross receipts and Arizona qualified research expenses either (1) for the first time in a taxable year beginning after December 31, 1983, or (2) for fewer than three taxable years beginning after 1983 and before 1989.

Fixed-Base Percentages for Taxable Years Beginning After 1993 in Which Start-Up Companies Incurred Arizona Qualified Research Expenses	
Taxable Year After 1993	Percentages for Taxable Years After 1993
1st through 5th	3 percent
6th	Divide the aggregate Arizona qualified research expenses for 4th and 5th taxable years by the aggregate Arizona gross receipts for 4th and 5th taxable years. Multiply the result by 1/6 (.1667).
7th	Divide the aggregate Arizona qualified research expenses for 5th and 6th taxable years by the aggregate Arizona gross receipts for 5th and 6th taxable years. Multiply the result by 1/3 (.3333).
8th	Divide the aggregate Arizona qualified research expenses for 5th through 7th taxable years by the aggregate Arizona gross receipts for 5th through 7th taxable years. Multiply the result by 1/2 (.50).
9th	Divide the aggregate Arizona qualified research expenses for 5th through 8th taxable years by the aggregate Arizona gross receipts for 5th through 8th taxable years. Multiply the result by 2/3 (.6667).
10th	Divide the aggregate Arizona qualified research expenses for 5th through 9th taxable years by the aggregate Arizona gross receipts for 5th through 9th taxable years. Multiply the result by 5/6 (.8333).
All years after 10th	Divide the aggregate Arizona qualified research expenses for any 5 taxable years selected by the taxpayer from among the 5th through 10th taxable years by the aggregate Arizona gross receipts for the selected taxable years.

If the percentage computation involves de minimis amounts of gross receipts and qualified expenses in a taxable year or short taxable years are involved, the amounts may be annualized or disregarded. Refer to IRC §§ 41(c)(3) and 41(f)(4) for details.

NOTE: The maximum percentage that can be entered on line 10 is 16 percent (.16).

Line 10 -

Multiply line 5 by 50 percent (.50). The base amount cannot be less than 50 percent of the current year qualified research expenses. This rule applies both to existing and start-up companies.

Line 12 -

Calculate the allowable credit amount according to the instructions in the following table. Enter the result.

Calculation of Current Taxable Year's Credit [taxable years beginning January 1, 2003 through December 31, 2003]	
If the amount on line 12 is:	Credit Calculation
Equal to or less than \$2,500,000	Multiply the amount on line 12 by 20 percent (.20)
More than \$2,500,000	\$500,000 plus 11 percent (.11) of the amount over \$2,500,000

Part II – Current Taxable Year’s Credit Passed Through From Partnerships and S Corporations

Line 13 –

Enter the aggregate amount from the Forms 308, Part II, line 20, and Part III, line 23, received from partnerships and S corporations. Attach a copy of the Form 308 received from the partnership or S corporation to your return.

Part III – Available Credit Carryover

Part III applies to a carryover of the credit for increased research activities from taxable years beginning January 1, 2001 through December 31, 2002. Since the credit for increased research activities applies only to taxable years beginning after December 31, 2000, there is no available credit carryover from taxable years beginning prior to January 1, 2001. Enter the total available carryover of the credit for increased research activities on page 1, Part III, lines 14 through 16.

Partners of a partnership or shareholders of an S corporation should complete Part III only if their allowable credit for increased research activities for prior taxable years exceeded their Arizona income tax liability for those taxable years. Since the credit applies to taxable years beginning after December 31, 2000, there is no available carryover of this credit from taxable years beginning prior to January 1, 2001.

Each partner or S corporation shareholder must complete Part III for the computation of the available carryover of the credit passed through by the partnership or S corporation.

In column (b), enter the credit originally computed for taxable years 2001 and 2002. In column (c), enter the amount of the credit from taxable years 2001 and 2002 which has already been used. Subtract the amount in column (c) from column (b) and enter the difference in column (d). Add the amounts entered on lines 14 and 15 in column (d). Enter the total on line 16, column (d). This is the total credit carryover available for the current taxable year.

Part IV – Calculation of Credit Carryover Limitation

This section applies to credit carryovers from taxable years beginning January 1, 2001 through December 31, 2002. Complete lines 17 through 23 to compute the total available credit for the taxable year. The unused portion of the tax credit may be carried forward for fifteen succeeding taxable years.

LIMITATION ON USE OF CARRYOVER OF CREDIT FOR INCREASED RESEARCH ACTIVITIES (FROM TAXABLE YEARS BEGINNING JANUARY 1, 2001 THROUGH DECEMBER 31, 2002). The portion of the available credit carryovers included in the amount from Part II, line 16, that may be claimed by the taxpayer is limited to the LESSER OF: (a) the tax liability [Form 301, Part II, line 32], or (b) \$500,000, MINUS the current year credit for increased research activities (regardless of the amount of the current year credit that is claimed on the tax return). [If the current year credit for increased research activities is \$500,000 or more, the taxpayer cannot use the credit for increased research activities carryover in that taxable year.] **NOTE:** The amount of the credit carryover claimed on the tax return may be further reduced if the taxpayer claims other nonrefundable tax credits.

Part V – Total Available Credit

Complete this section to compute the total available credit for the taxable year. The total available credit is the sum of the credit for current taxable year qualified research expenses and the available credit carryover.

Line 24 -

Add the amounts from Part I, line 12, and Part II, line 13. Enter the total.

This is the current taxable year's credit for increased research activities.

Line 25 -

Enter the amount from Part IV, line 23. **NOTE:** The amount of the credit carryover claimed on the tax return may be further reduced if the taxpayer claims other nonrefundable tax credits.

Line 26 -

Add the amounts on lines 24 and 25. Enter the total here and on Form 301, Part I, line 6.

This is the total available credit for increased research activities which may be applied to the current taxable year's tax liability. **NOTE:** If the taxpayer claims any other nonrefundable tax credits on the tax return, the amount of the credit carryover will be further reduced.