Freed Maxick Guide to the Federal Research and Development Tax Credit

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This guide is intended to help you understand how the Research and Development (R&D) Tax Credit may help you earn Federal tax credits for making research-based, qualified improvements to your business.

The R&D credit was created to encourage business investment in research for new ideas, discoveries and knowledge that would in turn support growth in the economy. A 2015 law made the credit a permanent part of the tax code, ending a decades-long cycle of expiration and reinstatement and making the credit a much more consistent and reliable resource for businesses. Many businesses can make more effective use of the R&D Credit if they have a better understanding of the basic law and how it might apply to them. This guide is designed to help you identify how your business' research and development activities may qualify for the credit and how you can claim the tax benefits it generates.

1. Overview of the Research and Development Tax Credit

The R&D Tax Credit was first added to the tax code on a temporary, renewable basis in the early 1980s. Up to that point, businesses could deduct R&D expenses from taxable income. The credit was created to provide an additional incentive (specifically, a reduction in income tax owed) for businesses to invest in innovations that would contribute to economic growth. For over 3 decades since its creation, however, the credit was subject to constant threats of expiration and last-minute extensions that made it hard to count on it for tax planning.

Congress acted in late 2015 to make the credit permanent and expand its applicability and benefits for existing businesses and start-ups. This action seemed to suggest a significant change in policy that could lead to wider acceptance by the IRS of legitimate R&D Tax Credit claims. It was followed closely by new rules from the IRS clarifying how certain expenses for software developed internally may qualify for the credit, further signaling that authorities were willing to support businesses that invested in developing ideas, discoveries and knowledge.

Put simply, the credit is available for costs related to any activity that relies on a technical discipline to improve a product or process. Projects that rely on hard science to generate a new or improved product or process where there is uncertainty about the feasibility of design could generate expenses that would qualify for the R&D Tax Credit.

Many businesses with qualified expenses fail to claim the credit because they assume it applies only to science-focused industries, like pharmaceutical development or technology production. The key to making a legitimate R&D Credit claim is understanding and allocating the costs that apply to any product or process improvement, regardless of how cutting-edge the taxpayer is (or isn't).

We'll provide more information on who is eligible for the Research and Development Tax Credit in the next chapter.

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2. Who Is Eligible for the Research and Development Tax Credit?

The short answer to the title question is, "More businesses than most people think." The most important answer is, "Quite possibly your business." Taxpayers often make two incorrect assumptions about the credit that lead them to ignore this valuable opportunity to reduce their taxes.

MYTH 1: They assume that the R&D Credit doesn't apply to their industry. This is incorrect because the credit is not in any way limited to companies in industries that are typically considered "research" industries, such as medicine or technology.

FACT: The credit is available to any business that makes "qualified research expenditures."Eligibility is determined by what you spend money on, not how your business makes money.

MYTH 2: They assume they aren't spending any money on research or development. This is incorrect because eligibility for the credit is determined by the tax law definition of "qualified research expenditures," not a scientific definition of "research" or "development."

FACT: The term "qualified research expenditures" encompasses a wide variety of costs that support research activities defined in the tax code, many of which would not occur to a scientist or engineer as research and development.

Now that we've addressed incorrect assumptions about who isn't eligible, let's take a closer look at who is eligible for the Research and Development Tax Credit. Any business can claim the R&D credit if it spends money on activities that meet a 4-part test:

- The activity must relate to a new or improved business component's function, performance, reliability, quality or composition.
- The activity must fundamentally rely on principles of physical sciences, biological sciences, computer science or engineering.
- The activity must be intended to discover information that would eliminate uncertainty concerning the capability or method for developing or improving a product or process, or the appropriateness of the product design.
- The activity must constitute a process of experimentation from simulation to refining or discarding hypotheses.

There's one more thing to note about the test. Nowhere does it say that your activity must succeed in creating a new or improved product or process. Failure does not disqualify an activity from the R&D Tax Credit. In fact, it can actually help show that R&D did occur. There are also some additional aspects of the credit that are available only for qualified small businesses and start-ups. Those will be detailed separately as well.

The 4-part test to qualify for the R&D Tax Credit

Best practices for exploring R&D credit eligibility

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3. How Is Eligibility for the Research and Development Tax Credit Assessed?

Once you understand the answer to Chapter Two's title question, "Who is eligible for the Research and Development Tax Credit," the next question that usually arises is "How is eligibility for the Research and Development Tax Credit assessed?" We hinted at the answer in the previous chapter, but it's important to state it clearly. Perhaps the best way to understand the answer is a process of elimination.

- Is eligibility assessed at the taxpayer level? No. Taxpayers who aren't operating as some form of business are not eligible for the credit. A person who fiddles around in the garage and inadvertently invents a gadget that betters humanity can't claim the credit unless the costs are incurred in connection with a trade or business.

- Is eligibility assessed at the business level? No. A taxpayer doesn't have to be in a certain industry or line of business to qualify for the credit. The costs that qualify for the credit must be in connection with a trade or business, but there is no limitation based on the type of business.

- Eligibility is assessed at the activity To qualify for the credit, the costs must be associated with research that is:
    - Technological in nature,
    - Intended to be useful in the development of a new or improved business component, and
    - Composed of activities that constitute elements of a process of experimentation.

The main takeaway from this is that any business can incur costs that qualify for the R&D credit. The 2 keys to making an accurate R&D credit claim are:

- Understanding the 4-part test that all activities must meet in order to qualify, and
- Properly tracking the costs associated with those activities.

We'll cover those topics more in Chapters 5 and 6.

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4. R&D Tax Credit Implications and Opportunities for Corporate and Individual Taxpayers Subject to AMT

As a means of reducing taxes, the R&D Tax Credit can be one of the most valuable incentives in the tax code. With a comprehensive eligibility assessment, proper documentation and acceptance by the IRS, companies of all types, sizes and life cycle stage are realizing tax benefits.

2017's Tax Cuts and Jobs Act (TCJA) did not change the credit. The law did, however, make the credit even more valuable to some businesses because of the elimination of the corporate alternative minimum tax (AMT).

Prior to the repeal, corporations subject to AMT in one year were provided limited relief in future periods through an offsetting credit to the extent that regular tax liability exceeded tentative minimum tax. R&D Tax Credits did not reduce tentative minimum tax (except for some eligible small businesses after 2015) and they were not refundable if they were more than the corporate income tax liability.

Basically, most corporations that had been subject to AMT would have to carry forward the benefit of their R&D Tax Credit until they were out of the AMT and beyond the period in which they recovered AMT credits against regular income taxes.

The TCJA eliminated corporate AMT, and it provided transition rules that will make the R&D Tax Credit valuable sooner to companies previously subject to AMT. Under the new law:

- If an AMT credit is carried forward into 2018 and beyond, and
- The value of the AMT credit exceeds the corporation's regular income tax liability, then
- The corporation can claim a refund for 50 percent of the amount by which the allowable credit for the tax year exceeds the regular tax liability.
- Beginning in 2021, the refundable amount rises to 100 percent of the excess.

In short, corporations with AMT carry-forwards may qualify to get more of those carry-forwards back as refunds sooner if the R&D Tax Credit reduces their current-year regular tax liability.

Owners/shareholders of Sub S corporations, LLCs and sole proprietorship's that qualify as an "eligible small business" (ESB) – average annual receipts of less than $50 million per year for a 3-year period – can use the R&D tax credit against their personal AMT due. If the company is an ESB, the Credit "flows through" the business straight down to the personal return of the owner. Owners/shareholders will need to do a calculation to determine the portion of the company's R&D Credit they can use and apply against their personal AMT liability.

These calculations are not as cut and dry as they may appear at first blush. They're one of the last steps in a process that begins with assessing applicability and eligibility, continues with documentation, and concludes with successful interactions with the IRS. We recommend that you engage a qualified team of R&D Tax Credit experts that can discuss costs and benefits of doing an R&D Study, weighed against the tax minimization opportunities available to you.

Why you might want to wait on an R&D Tax Credit Study

Tax Reform and the Federal R&D Tax Credit for Corporations

Brewing up Tax Savings with the Federal R&D Tax Credit

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5. The Four Part Research and Development Tax Credit Qualification Test

We've talked about how the Research and Development (R&D) Tax Credit can minimize tax burdens and in the process, help to improve cash flow in your business. The first question most business owners ask about the credit is, "do we qualify?"

Generally speaking, if you are actively creating or improving products and processes using hard sciences or technology, you're on your way to claiming the credit. If your claim is successful, you'll see your Federal taxes reduced by some portion of the costs you've incurred.

This chapter, and other blog posts we've published will help you identify activities which qualify for claiming the credit. No matter what business you're in or what type of research is involved, an activity needs to meet the four-part Research and Development Tax Credit qualification test in order for related costs to be eligible for the credit.

TO QUALIFY FOR THE CREDIT, AN ACTIVITY MUST BE:

1. **Conducted for a permitted purpose** - related to producing new or improved function, performance, reliability, quality, or composition.
2. **Technological in nature** - by fundamentally relying on principles of physical sciences, biological sciences, computer science, or engineering.
3. **Intended to eliminate of uncertainty** - regarding the capability or method for product or process improvements and/or or the appropriateness of a product's design.
4. **A process of experimentation** - involving simulation; evaluation of alternatives; confirmation of hypotheses through trial and error; testing and / or modeling; or refining or elimination of hypotheses.

Examples of qualifying activities could also include advancing the design of an existing product or process, correcting design defects, finding ways to reduce costs, or finding ways to enhance functions. Design, construction, and testing of prototypes or models may also qualify. Some activities, ranging from funded research to reverse engineering, are specifically excluded from the R&D credit by law.

Our blog post below, **The 4-Part Test to Qualify for the R&D Tax Credit,** goes into greater detail on inclusions and exclusions. In the chapters ahead, we'll focus on how to document your R&D costs and calculate your R&D tax credit.

The 4-part test to qualify for the R&D Tax Credit

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6. Documentation for the Research and Development Tax Credit

In order to support a claim for this benefit, a taxpayer must create and maintain thorough and accurate documentation for the research and development tax credit. Most general ledger systems that focus solely on preparing financial statements or tax returns do not adequately correlate the qualified research activities (QRAs) to back up the qualified research expenses (QREs) that the company is attempting to claim.

What documentation is needed?

Records and documents that support a claim for an R&D tax credit include:

- Financial information, including wages paid to employees working on R&D activities.
- Records of QRAs, preferably in separate accounts. For instance, supplies used for R&D purposes should be tracked separately from those used for non-R&D.
- Time allocations, supported by workplans, payroll records, committee meeting minutes, etc.
- Design drawings displaying various iterations. Testing documentation can also support successes and failures. (Remember, the research does not have to be successful in order for the related costs to qualify for the credit.)

What are the best ways to collect documentation?

- Use time-and-expense tracking software to track activities on a project-by-project basis: Wages are usually the largest component of an R&D tax credit claim, so an investment up-front in creating a system that tracks time carefully can make compliance much easier when it comes to filing a tax return.
- Have employees prepare monthly or weekly summaries of their projects: Contemporaneous documentation always carries more weight if your claim is examined by the IRS. However, these records are subject to more human error as trying to retrace activities at the end of a week or month could lead to honest mistakes or oversights in time calculations.
- Designate a manager to accumulate others' qualified R&D time: There's an advantage to having one highly trained individual evaluating all time spent to determine what qualifies as R&D. Potential downsides include that one person could consistently misinterpret information and magnify a miscalculation across all employees. Also, it can be very difficult for one person to have a clear picture of what every employee did.
- Backfill R&D activities once a year: Probably the least reliable and least desirable of the methods, it's subject to errors and omissions due to the forgetfulness of employees and it's also more time intensive trying to interview employees about time and expenditures that may have happened months ago.

The IRS rules are not specific about what constitutes sufficient documentation for the research and development tax credit, but the Service has shown a strong preference for contemporaneous documentation. The more detailed your records and the more frequently they are prepared and maintained, the more likely they will support a claim for the credit if the IRS should choose to question your return.

R&D Tax Credit Documentation: What you need to know

Four R&D Tax Credit documentation methods

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7. How to Do a Research and Development Calculation

For most companies engaged in activities that qualify for the R&D Tax Credit, the most significant source of qualifying R&D costs also turns out to be the most frequent source of R&D credit miscalculation: wages. It's rare that any employee spends 100 percent of his or her time on activities that qualify for the credit. The means by which your employees allocate their time to qualifying activities will determine how accurate your claim is.

Here are 3 steps to make the calculation more accurate:

1. **Don't rely on a controller / CFO-type to do the claim work.** You need an in-house subject-matter expert to work with accounting personnel to review the time spent on R&D projects and make sure the allocations are accurate.

2. **Document your claims for the credit thoroughly.** Timecards, reports, minutes - anything that points to the innovation involved and the challenges faced in performing the research. Document failures as thoroughly as successes. Failures and related lessons learned can contribute to demonstrating a "process" of innovation that will help support your claim.

3. **Identify weaknesses in your documentation process.** If you find you're spending significant amounts of time reconstructing time allocations at the end of the year, explore options for tracking the time in a more accurate and contemporaneous fashion as research is performed.

One approach that has clearly proven ineffective over the years is a year-end review by a CFO or controller who attempts to assign a blanket percentage of a group's time to qualifying research activities. It's one thing to wait until the end of the year to try and analyze and calculate a research tax credit based on specific data, but it's something else entirely to just multiply a department's wages by a set percentage.

When you're trying to figure out how to do a research and development calculation, the two key elements are specific details about the qualifying activities and contemporaneous records of the time and expenses allocated to those activities.

R&D Tax Credit calculation: Using the proper method to calculate R&D wages

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8. The Research and Development Tax Credit for Startups and Small Businesses

Sometimes, the businesses that need a tax break the most have the hardest time qualifying to get one. For instance, startup companies often sink significant amounts into research and development. During their early years, though, they often operate at a loss for tax purposes. Until a 2015 law change, the R&D tax credit could only reduce income taxes on profits, meaning companies showing a loss for income tax purposes were unable to benefit from the provision.

That law change allowed qualifying small businesses to claim the R&D credit as an offset against the employer's portion of FICA taxes. A business can claim the credit against these payroll taxes if:

- It has less than $5 million in gross receipts for the current year, and
- It has no gross receipts for any tax year before the five-year period ending with the current tax year.

Generally, the portion of the credit eligible to offset payroll tax is limited to the lesser of $250,000, the current year credit, or, for regular corporations, the amount of the credit carryforward from the tax year determined without regard to the election.

Another rule expands the applicability of the R&D credit for small businesses regardless of their age. Partnerships, sole proprietorships, and privately held corporations may be able to claim the R&D credit against an alternative minimum tax liability. In order to qualify, the annual gross receipts of the business can not exceed $50 million in the three-tax-year period preceding the year in which the credit is claimed. These provisions give businesses that might not be large enough or established enough to generate regular income tax liabilities an opportunity to reduce other types of taxes that typically arise much earlier in their life cycle.

Time to investigate your possible R&D Tax Credit

New opportunities for the R&D Tax Credit

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9. Getting Started on Claiming the Research and Development Tax Credit

After seven chapters detailing how much your business could benefit from this provision, you're probably wondering how to get started on claiming the Research and Development Tax Credit. Here are a few tips to help you build a strong foundation to support your claim.

Think Broadly

We've said it before, but it bears repeating–you don't have to be a science-based business to benefit from the R&D Tax Credit. Manufacturers who experiment with process improvements may qualify. Businesses that develop software for internal use, even in-house spreadsheets, may have a legitimate claim for the credit.

Any activity that relies on a technical discipline or some kind of "hard science" to improve a product or process could generate qualifying expenses. When your business engages in a development process that requires experimentation and the outcome is uncertain, the credit could be in play. Remember that these rules weren't written by scientists for scientists, they were written by legislators and tax administrators for businesses.

Document Early and Thoroughly

The earlier you start documenting a qualifying activity, the easier it will be to claim the credit. Any time your business considers creating or improving a product or process, start tracking the labor and expenses associated with the project.

- **Document amounts:** This part isn't rocket science, just good old-fashioned accounting.
  Keep your receipts. Allocate employee time accurately.
- **Connect amounts to activities:** Your accounting system can be your greatest asset.
  Set up discrete project codes as early as possible in the process to track the time and money specifically devoted to the project.
- **Show how activities qualify:** This area may be a little bit more tricky, as businesses often don't think of these documents as "tax r ecords." In addition to money and time, document the process itself with items like progress reports, minutes of relevant meetings and design sessions, and testing documentation. If the work results in a patent (or even a patent application), documents that support the application are certainly relevant.

If at First You Don't Succeed…

…Your claim for the credit may be even stronger. Failures and trips "back to the drawing board" are evidence of a "process of experimentation." Keep in mind that it's a "Research and Development Tax Credit," not a "Successful Finished Product Tax Credit."

Seek Professional Help

As we noted earlier, the R&D Tax Credit rules were written by legislators and tax administrators for businesses. If you think your business may be working on product or process that qualifies, it can be very helpful to discuss with an Advisor who is familiar with how the IRS and the courts have interpreted similar claims in the past.

For a closer look at the specific facts and circumstances of your business, contact Freed Maxick for help getting started on claiming the Research and Development Tax Credit.

What to prepare for and expect from your first meeting about the R&D Tax Credit

The process to claim your possible R&D Tax Credit

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