Research and Development Credit Overview

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Background

The Research and Development Tax Credit ("R&D Credit") was enacted in 1981 as part of the Economic Recovery Act. The R&D Credit has been renewed and extended every two years since its original enactment, until it became a permanent part of the tax code in 2016. The R&D Credit allows companies, of any size, to claim a dollar-for-dollar reduction in tax liability for conducting qualified research within the United States. This qualified research is identified by examining qualifying research activities and then subsequently isolating expenditures related to employee wages, outside consulting costs, and certain material expenses. Taxpayers may claim credits back three years and carry forward unused credits for up to 20 years.

What Qualifies

When individuals think of research and development, they typically imagine a setting involving test tubes and lab coats. However, when it comes to the tax code, the definition of what may qualify as research and development is extremely broad, and includes any work performed that involves design or development to create a new or improved **business component.**

The following four-part test outlines the requirements necessary for claiming the R&D Credit:

1. **New or Improved Business Component:**

   The taxpayer must design or develop a new or improved product, process, formula, invention, technique, or software. These are the six enumerated business components as defined in section 41 of the Internal Revenue Code.

2. **Elimination of Uncertainty:**

   The taxpayer must seek to eliminate uncertainty regarding the design or development of the new or improved business component. This test is commonly known as the hypothesis stage, where initial ideas and concepts are formed to eliminate unknowns to enable the taxpayer to proceed with design or development.

3. **Process of Experimentation:**

   The taxpayer must engage in a process of experimentation by evaluating one or more alternatives that eliminates the uncertainty encountered at the outset of design or development. This test is defined broadly to include trial and error testing, evaluating the capability of alternative ideas or concepts, and utilizing any set of broad scientific principles to overcome uncertainty encountered during design or development.

4. **Technological in Nature:**

   The taxpayer must base their process of experimentation on the principles of the hard sciences, such as utilizing the principles of engineering, computer science, or the life sciences.

Who Qualifies

Industries that qualify for the R&D credit are extremely expansive. Below is a non-exhaustive list of qualifying industries:

- **Software**
- **Architecture**
- **Bioscience**
- **Breweries & Wineries**
- **Electrical & Mechanical Contracting**
- **Manufacturing**
- **Pharmaceutical**
- **Engineering (Civil, Mechanical, Structural)**

2016 Updates and Enhancements

Permanent:

In December of 2015, Congress passed the PATH Act that made the R&D credit a permanent part of the tax code. This was a big win for small and medium sized businesses. Companies can now forecast and budget accordingly knowing the credit will be available for years to come.

Payroll Tax:

One of the enhancements to the R&D credit was the ability to offset payroll tax for startup companies. Qualified Small Businesses (less than $5 million in gross receipts and with gross receipts of 5 years or less) can use the R&D Credit to offset employer payroll tax, which is capped at $250,000 for each applicable tax year beginning in tax year 2016. This allows companies who are not profitable, but still conducting R&D activities to take advantage of the credit.

Alternative Minimum Tax (AMT) Turnoff:

AMT turnoff has now been applied to all tax years moving forward as of 2016. To qualify for the AMT Turnoff, businesses have to meet the requirements of an "Eligible Small Business". Eligible Small Businesses (less than $50 million in average gross receipts for the preceding 3 years) may use the R&D Credits to offset their Alternative Minimum Tax beginning in tax year 2016. This enhancement is especially beneficial to companies who may be conducting R&D activities but could not take the credit due to AMT limitations in the past.

Our Process

PHASE 1

During this phase, we gather preliminary financial and project information to develop a high-level credit estimate for the selected tax years. If no potential credits are identified, credits are minimal, or it would not make sense to proceed with the credits from a taxpaying position, we terminate our contract at no cost.

PHASE 2

During this phase, we work closely with the client to gather detailed employee and project information and documentation. Additionally, we conduct interviews to establish qualifying employee activities and tie those qualifying activities to projects or endeavors the company undertakes. This allows us to refine our high-level estimate and calculate a final tax credit for the company.

PHASE 3

During this phase, we document a deliverable that substantiates the company's research and development activities as it relates to all qualifying expenditures. The report includes applicable statutory and regulatory information to ensure that all components of the claimed R&D Credit are accounted for and will withstand IRS scrutiny.

Find Out If You Qualify

Are you ready to learn more about the Research and Development credit or find out if you qualify? Schedule time with Jennifer Varteressian, Esq., a Wealth Advisor that specializes in taxes for Forefront Tax Partners at the calendar link below!

GET STARTED