

WHITE PAPER

How the R&D tax credit could benefit your business



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It's not just for tech or manufacturing firms – many companies don't realize they can take advantage of the R&D tax credit. For those that may qualify, it's important to keep good records and understand exactly which expenses you can receive a tax credit for.

If you're developing new or improved products, software or manufacturing processes, or engaging in engineering, scientific or technical services, the federal credit for increasing research activities (also known as the R&D tax credit or research tax credit) could potentially save you thousands of dollars in taxes and help you reduce the cost of research and development.

Companies in technology, manufacturing, healthcare, software (including software-as-a-service) and other industries are often eligible for this credit. However, many business owners either don't know about the credit, think it's not applicable to them or that it's only for large corporations, or believe it's too complicated to qualify for. As a result, they could end up missing out on significant tax savings for their business.

This white paper answers several frequently asked questions about the R&D tax credit. Read on to learn more about this lucrative tax incentive and how it may benefit your business, including:

- *The value of the tax benefit*
- *Which types of industries, companies and activities may qualify*
- *Requirements for qualifying*
- *How and when companies can use the credit*
- *How the credit is calculated and substantiated*
- *Examples of eligible projects*
- *How to get started*

WHAT IS THE RESEARCH TAX CREDIT?

First enacted by Congress in 1981, the Credit for Increasing Research Activities, commonly known as the R&D tax credit or research tax credit, is a federal tax incentive for businesses to increase their investments in research and development. Under Section 41 of the Internal Revenue Code, the credit allows qualifying taxpayers to reduce their tax liability based on their annual Qualified Research Expenses (QREs). QREs include certain expenses paid or incurred while conducting Qualified Research Activities (QRAs).

Qualified Research Activities are not limited to work done by scientists or engineers in laboratories, but, rather, include a variety of activities that many taxpayers conduct in order to remain innovative and competitive.

WHAT IS THE TAX BENEFIT?

The federal research credit is a dollar-for-dollar offset of federal taxes paid or owed. Unlike a tax deduction, which reduces a taxpayer's taxable income, the R&D tax credit reduces a tax liability.

The R&D tax credit is a dollar-for-dollar offset of tax paid or owed.

The credit is calculated using one of two methodologies (which we will cover later), and its actual benefit typically represents 6%–10% of a company's Qualified Research Expenses for the year.

Taxpayers claim the credit on their tax return using IRS Form 6765 – Credit for Increasing Research Activities and Form 3800 – General Business Credit.

WHICH INDUSTRIES MIGHT BENEFIT FROM THE RESEARCH TAX CREDIT?

The R&D tax credit is available for businesses performing qualified research in a broad range of industries. Too often, taxpayers overlook the opportunity to claim the R&D tax credit under the assumption that it's only available to large corporations or specific industries.

Qualified research, as defined by the tax code and the regulations, can occur almost anywhere there is a tangible product, software or a transformation process. It does not have to be conducted by scientists or engineers and it does not have to take place in a laboratory setting.

Companies in a wide range of industries, from healthcare to financial services, can potentially qualify. Industries in which the R&D Tax Credit is frequently captured include, but are not limited to the following:

- *Aerospace*
- *Agriculture*
- *Architecture & Engineering*
- *Biotechnology*
- *Financial services (for IT-oriented projects)*
- *Fintech*
- *Food & Beverage*
- *Manufacturing*
- *Medical device development/manufacturing*
- *Pharmaceuticals*
- *Software development*
- *Technology*
- *Video game development*
- *Other service providers that perform IT-oriented research and development*

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HOW CAN THE TAX CREDIT BE USED?

Offset income taxes

Generally, the federal research tax credit is used to offset federal income taxes owed by the entity paying or incurring the Qualified Research Expenses. In the absence of a tax liability, a taxpayer can generally carry-forward the credit for future utilization (up to 20 years). The credit can also be carried backward for one year. Corporations (C-corps) can transfer unused R&D tax credit to a buyer in the context of a sale or exit; this is subject to certain limitations.

For pass-through entities such as S-corps and partnerships, the R&D tax credit flows to shareholders or partners through their respective K-1s. Shareholders or partners use their share of the R&D tax credit to offset taxes paid or owed in connection with the income (ordinary wages, guaranteed payments or business income) derived from the entity generating the R&D tax credit.

Startups: offset payroll taxes

Eligible startups can use their R&D tax credit to offset payroll taxes. This means startups without a federal income tax liability can receive an immediate benefit for the credit at a stage of the business when it may be needed the most.

To qualify, the taxpayer must satisfy the following criteria:

- *Less than \$5 million in gross receipts in the year the credit is claimed*
- *No gross receipts prior to the five-year period ending with the credit year*

This credit can offset up to \$500,000 of payroll taxes per year for up to five years – boosting cash flow for key growth initiatives.

WHAT ARE THE REQUIREMENTS TO QUALIFY FOR THE R&D TAX CREDIT?

Eligibility for the research tax credit is established on a project-by-project basis. To qualify for the research tax credit, a taxpayer's project must meet all of these criteria:

- 1. The purpose of the activities conducted is to develop a new or improved business component sold or used by the company. A business component can be a product, process, technique, formula or software. The activities must be expected to lead to new or improved performance, function, reliability or quality for the business component*
- 2. The activities were performed to eliminate a technical uncertainty identified at the onset of the project. The technical uncertainty must relate either to the taxpayer's capability, the method it chooses to follow or the appropriate design to develop or improve the business component.*
- 3. Substantially all (80% or more) of the activities conducted in the project must follow a systematic process of experimentation. This process involves evaluating different alternatives through activities such as modeling, simulating, testing, experimenting, etc.*
- 4. The process of experimentation must be technological in nature and rely on hard sciences such as engineering, physics, chemistry, biology or computer science.*

The formal qualification criteria are known as the "four-part test." To qualify for the tax credit, R&D activities must pass the four-part test.

The R&D tax credit was enacted as an incentive for businesses to increase their investments in research and development activities so they remain globally competitive.



WHAT TYPES OF ACTIVITIES QUALIFY FOR THE R&D TAX CREDIT?

Contrary to some misconceptions, a wide range of activities are considered Qualified Research Activities and may be eligible for use in claiming the research tax credit. In fact, eligibility for the credit is not limited to basic research, new product development, or laboratory research. It also includes many activities relating to the improvement or enhancement of existing products, software, or manufacturing and transformation processes.

CAN PROTOTYPES AND PLANT EXPERIMENTS QUALIFY FOR THE R&D TAX CREDIT?

Projects requiring the development/construction of prototypes or the conduct of experiments in a plant-based environment may qualify for the credit. These can present complex challenges in terms of establishing when a technical uncertainty is solved and when qualified research ends.

It is critical to document and substantiate when the research and development begins and ends, as it can have a major influence on the size of a research tax credit claim. A tax professional with R&D tax credit expertise can help you understand these parameters under the tax rules and make sure the proper documentation is created and retained.

CAN COMPONENTS OF A LARGER PROJECT QUALIFY FOR THE RESEARCH TAX CREDIT, EVEN IF THE LARGER PROJECT DOES NOT?

Sometimes components of a project can qualify for the R&D tax credit. The shrinking-back rule may allow a company to claim the research tax credit for qualifying components of a larger project, even when the larger project might not qualify as research and development. A professional can help you understand which components of a project might qualify.

WHAT TYPES OF R&D PROJECTS ARE USUALLY EXCLUDED FROM THE RESEARCH CREDIT ELIGIBILITY?

There are several exclusions to the R&D tax credit that can be particularly complex to interpret in the context of research projects.

These include:

- *Research conducted after commercial production begins*
- *Funded research*
- *Adaptation of an existing business component*



WHAT TYPES OF EXPENSES MIGHT QUALIFY?

Expenses that may be used to calculate the tax credit, known as Qualified Research Expenses, must be paid or incurred by a taxpayer while performing Qualified Research Activities.

Types of expenses that could potentially qualify for the credit include:

- *Wages for personnel involved with qualifying projects, including direct supervision or support of development work*
- *Supplies used in the R&D process (such as raw materials, parts used in prototypes or certain materials used in performing research)*
- *Cloud computing expenses for hosting a development environment*
- *Outside contractor costs for research and/or development performed in the U.S. where the taxpayer is at risk for the failure of the research; 65% of these costs may qualify*

QUALIFIED RESEARCH EXPENSES (QRES)

IN-HOUSE

Internal Wages

- Directly engaged in qualified research
- Directly supervised qualified research
- Directly supporting qualified research

Supplies

- Materials used in performing research
- Supplies used in prototyping activities

CONTRACT RESEARCH

- 65% of regular contracts
- 75% of research consortia contracts
- 100% for certain energy research contracts



These expenses do not qualify for the credit:

- *Equipment*
- *Tangible property subject to depreciation*
- *Indirect supplies*
- *Overhead*
- *Market research*
- *Support for administrative activities*
- *Work completed outside the United States*

WHAT ARE EXAMPLES OF POTENTIALLY ELIGIBLE PROJECTS?

Although the requirements may seem complex, many projects – even those you might not think of as being R&D – may be eligible for the credit. In addition to basic research performed in a lab and new product or software development, numerous initiatives could also qualify for the research tax credit (assuming that they meet the four technical requirements).

Projects you might not associate with R&D can be eligible for the credit, which is available for more than just basic lab research and new product development.

The following are several examples of work that may qualify for the R&D tax credit.

In a range of industries:

- *Developing new tangible goods or products*
- *Developing software*
- *Improving the performance or quality of an existing product or software*
- *Developing new functionalities for a product or software*
- *Developing proofs-of-concept and prototypes*
- *Conducting experimental trials on production lines to develop a new product*
- *Automating complex processes*
- *Investigating and testing how to introduce new sources of energy*
- *Developing new processes with novel combinations of equipment and technologies*

Manufacturing:

- *Improving the performance of a manufacturing process*
- *Experimenting with alternative or new raw materials*

Biotech, Healthcare and Pharmaceuticals:

- *Developing new drugs and therapies*
- *Conducting clinical trials in the U.S.*

- *Developing techniques and processes to manufacture novel drugs*
- *Improving the efficacy and safety of certain drugs or medical devices*
- *Developing software applications for telemedicine or delivery of healthcare management*
- *Developing electronic medical record solutions or patient-engagement tools*
- *Developing Internet of Things devices for medical uses*
- *New API development*
- *Improving existing APIs*
- *Developing new functionalities or enhancing functionalities for existing software*
- *Designing/developing new architecture to improve a system's performance, maintainability, stability, reliability, etc.*
- *Experimenting with and investigating alternatives to improve processing speed and stability of existing systems*
- *Improving the scalability or performance of software or an application*

Financial Services:

- *Developing online banking applications.*
- *Developing mobile applications*
- *Redeveloping an old application in a cloud-based environment*
- *Developing tools to enhance data protection and cybersecurity*
- *Advances to communication protocols and data transmission speed between systems*
- *Developing communication bridges between systems that don't currently communicate with each other*
- *Investigating approaches to enable data exchange and synchronizations between systems*

Technology or software development (may be undertaken by a company in any industry):

- *Design, building and testing of new applications, platforms or systems*
- *Testing of systems being developed*

HOW IS THE R&D TAX CREDIT CALCULATED?

The credit can be calculated in accordance with two different methodologies: the Regular Credit and the Alternative Simplified Credit. The choice of methodology is determined based on factors such as the taxpayer's historical Qualified Research Expenses and gross receipts, as well as other attributes.

Regular credit computation

The regular credit calculation computation involves historical QREs and gross receipts. The credit equals 20% of the QREs above a basis determined based on the QREs and gross receipts of prior years. By design, the credit can never be more than 10% of the total QREs paid or incurred in the credit year. Using the regular credit method could require taxpayers that have been in existence for several years to pull data all the way back to inception in order to calculate a fixed-base ratio. However, the regular credit is well-suited for startups and early-stage companies that have been in existence or incurring R&D expenses only for a few years.

Alternative Simplified Credit

The Alternative Simplified Credit, aka the ASC, does not involve a taxpayer's gross receipts. Instead, it compares the credit year QREs to the QREs spent over the prior three years. Taxpayers are allowed a 14% credit for the amount of qualified R&D expenses incurred that exceeds 50% of the average QREs incurred over the three preceding tax years.

Which method to choose depends on each taxpayer's unique circumstances and the evolutions of their QREs through the years. Businesses should consider engaging a tax professional with R&D tax credit expertise to assist with identifying which activities may be eligible, as well as calculating and substantiating the credit.



HOW ARE RESEARCH TAX CREDITS SUBSTANTIATED?

Even though the research tax credit's scope of applicability is wider than many taxpayers expect, claiming it requires proper substantiation and documentation.

Without proper substantiation and documentation, a taxpayer risks:

- *Not taking full advantage of the credit they're eligible to receive*
- *Denial or revocation of the tax credit by the IRS*
- *Possible penalties for taking a research tax credit that cannot be properly substantiated*

It is crucial to implement an efficient supporting documentation methodology to substantiate an R&D tax credit. This will include documenting the process of experimentation, establishing and documenting when a technical uncertainty was solved, and showing your reliance on hard sciences. It is also important to clearly distinguish and quantify the costs associated with the performance of qualified research services, versus the costs associated with activities performed in direct support or in direct supervision of research.

An R&D tax credit professional can develop, implement and maintain the documentation and record-keeping required for the research tax credit.

A research tax credit professional can help you navigate substantiation and documentation, including the engineering, development and tax issues it entails. A professional can also develop, implement and maintain enhanced document retention plans, as well as develop and maintain a system for more detailed time-keeping and clarity on research, support and supervision activities.

Professionals with a background in both engineering and tax can be particularly valuable in the research tax credit process. They can document the process of experimentation, including where it begins and ends, in the language and form the IRS is looking for. They're generally able to bring clarity to the lines between experimenting, prototyping and non-qualified activities.

Substantiation of the R&D tax credit constitutes one of the most challenging issues for many taxpayers. But that should not deter you from exploring whether you can claim this lucrative credit.

It's also important to pay attention to potential changes to expensing research and development. For instance, starting with the 2022 tax year, R&D expenses can no longer be expensed immediately. U.S.-based R&D expenses must be capitalized and amortized over five years; international expenses must be capitalized over 15 years. While a postponement of this new capitalization regime has been proposed in Congress, it remains uncertain if lawmakers will pass any legislation and when such legislation could be enacted.

Taxpayers should be proactive about consulting with their tax advisors about this and other recent and pending administrative, judicial and legislative developments that could impact how they prepare and file their R&D tax credit.

HOW CAN I GET STARTED?

The R&D tax credit continues to be a lucrative tax incentive for businesses investing in research and experimental development. However, this value-driver comes with a complex set of regulations that can render the claim preparation process burdensome.

Working with experienced R&D tax specialists can go a long way to maximize credit benefits while also minimizing compliance risk related to insufficient documentation and substantiation. Companies should rely on the expertise of R&D tax specialists to help identify the projects that will satisfy the tax code requirements, properly document eligible research activities, verify calculations of qualifying expenses, accurately track tax credits and claim your research tax credit.

Kaufman Rossin's R&D tax professionals have years of experience helping businesses qualify for and capture research credits. With backgrounds in engineering and tax expertise, they combine technical savvy with deep experience in your industry to guide you through the entire process. Contact a member of Kaufman Rossin's Cost Segregation, Credits & Incentives team to learn more about how your business may benefit from the R&D tax credit.

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