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CERTIFIED PUBLIC ACCOUNTANTS



What You Need to Know About R&D Tax Credits



The research and development tax credit is a longstanding tax credit that's proven to be beneficial for many businesses, large and small. It became part of tax code in 1981 as part of The Economic Recovery Tax Act. Though the credit was originally temporary, it was extended 15 times before finally becoming a permanent credit in 2015. The credit extends to both federal and state taxes, and businesses can even elect to use the credit on payroll taxes in certain situations.



How does the R&D credit benefit businesses?

In 1981, The Economic Recovery Tax Act was implemented to help bolster the U.S. economy by providing tax incentives to companies. As part of this act, the R&D tax credit's purpose is to encourage the research and development of new products and improved processes. This tax credit has many benefits for small businesses, including the reduction of tax bills for not only the current year, but future years as well, since the credit can carry over for up to 20 years. Small to mid-size businesses may also use the credit to offset payroll tax, provided they meet certain requirements.





Do you qualify for the R&D tax credit?

Because they lack a dedicated research and development team, many businesses believe that they don't qualify for the R&D tax credit. In many cases, they are mistaken. Any company that spends money on R&D expenses may qualify for the tax credit if they pass the four-part test listed below.





What qualifies as R&D activities?

- Developing a new product
- Designing a new product
- Engineering a new product
- Researching possible new products
- Research that leads to new information
- Testing research findings
- Designing alternatives to existing products
- Testing alternatives to existing products
- Modifying current product concepts or designs, as long as the modifications are considered significant
- Experimenting with new designs or technologies
- Experimenting with new materials or prototypes
- Engineering or testing product modifications

These activities all qualify whether someone on your team performs the task or you hire an outside consultant, as long as the consultant is based in the U.S.



Four-Part Test

Now that you know which activities qualify as R&D, you should ensure that your company and its activities meet the four-part test, which is the basis for eligibility. Remember, your R&D activities need to meet all four of these criteria to qualify.



Elimination of Uncertainty

The R&D must be conducted with the purpose of eliminating uncertainty about the product. In simple terms, this means that research and development for aesthetics purposes does not qualify for the tax credit. There may be exceptions, but cosmetic product changes usually do not apply.



Permitted Purpose

The product must have some form of improvement. This may include improvements in performance, quality, function, or reliability.



Process of Experimentation

Your process must include experimentation. This may be shown with models, hypotheses, or other scientific methods.



Technological in Nature

The activities must be based on science or engineering. Computer science, biology, chemistry, and other “hard” sciences qualify.


Which types of products qualify for R&D credits?

There are many types of products or developments that qualify for the R&D credit, but these are some of the most common:

- Software development (including apps)
- Dies
- Molds
- Patents
- Certification testing
- Environmental testing
- Automated manufacturing processes

Which industries or activities are excluded from R&D credits?

Though the qualifications for the R&D credit are fairly loose, certain activities and products are specifically excluded. These include:

- Consumer surveys
 - Acquisition of patents or models
 - Management studies
 - Ordinary testing or inspections
 - Efficiency surveys
 - Reverse engineering
 - Foreign research
 - Research related to social sciences, arts, or humanities
 - Routine data collection
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What expenses qualify as R&D?

There are few limits on expenses that qualify for the R&D credit, as long as the activities meet the four-part test listed above. The four categories of expenses include:



Salaries: Most of the credit usually comes from wage expenses paid to employees. These expenses must be for “qualified services,” which include engaging in qualified research, supervising qualified research, or supporting qualified research.



Legal fees



Contractor fees: If you hire a contractor to perform any of the qualified services listed above, you may deduct up to 65 percent of those fees. The contractor must be based in the U.S., however, to qualify.



Supplies: Supplies are included as long as they are directly related to the R&D. Supplies may not include land or any depreciable assets. Travel, shipping, and royalty expenses are also specifically excluded.



Basic research payments: Some companies hire nonprofits to conduct some aspects of the research. In this case, 75 percent of the expenses are allowed.



Are there other limitations?

The tax credit is nonrefundable. That means that, while you can reduce your overall tax burden, you won't receive a credit if you owed no taxes for the year. However, you should note that it is a dollar-for-dollar credit, which offers a greater benefit than most tax deductions.

You should also know that the tax credit can be carried forward for 20 years or carried backwards for one. So, even if you don't owe any taxes this year, the credit may be useful for other years. You can file amended returns on prior returns or claim the credit on future returns.



Extra Benefit for Small Businesses

In addition, though the credit is nonrefundable, some small businesses can use the credit against their payroll taxes. This benefit works well for companies who don't owe federal or state taxes. To qualify, you must have:

- Gross receipts for five years or less
- An average of no more than \$5 million in gross receipts for the last five years

You may elect to use either the federal tax credit or the payroll tax credit. The payroll tax credit has a limit of \$250,000 per year for up to five years maximum.

Conclusion

If you believe you may qualify for the R&D tax credit, the advantages can pay off substantially. It's also possible that you may qualify for prior tax years, leaving the IRS owing you money, which you can use immediately. As with any tax credit, be sure to keep all records in case of an audit. These include receipts and documentation for your R&D projects, including emails, paperwork, payroll records, etc.

If you have any further questions or want to know about the R&D tax credit, contact one of our professionals for assistance.



About us

At Raven A. Herron & Company we perform many different types of accounting and tax services to meet the needs of both individuals and business owners. We understand the importance of having a well organized, knowledgeable team guide you through the ever-changing economic landscape.

Our team of professionals have become known for providing expert analysis and excellent customer service. Additionally, our service offerings are supported by the industry's latest technologies, providing more customized services and giving you greater access to the pertinent financial information you need to make well-informed decisions.

Contact Raven A. Herron & Company whenever you find you need more than just an accountant, but a partner who takes pride in watching you succeed.



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