

What You Need to Know: The Research and Development Tax Credit



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INTRODUCTION

What You Need to Know: The Research and Development Tax Credit



When we initially meet with small business clients, they sometimes lament that the federal government isn't as supportive of their contributions to society as they'd like. They envision a world where innovation not only fuels their business growth but also earns them a significant tax break.

As it turns out, in some respects, this is already a reality. The Credit For Increasing Research Activities (*aka, the Research and Development (R&D) Tax Credit*) – which first appeared as part of the Economic Tax Recovery Act of 1981 – is an often-overlooked tax incentive that serves as a powerful tool that may put money back into your business' pocket for the inventive work you're already doing. In this SWC Business Brief, we share what you need to know to take advantage of this important tax credit.

If any part of your business involves designing, developing, or improving products, processes, formulas, or software, be sure you're claiming a federal Research and Development (R&D) Tax Credit and any R&D tax credits your state may be offering to offset the costs of these activities. The federal benefit provides a dollar-for-dollar credit against your business tax for the costs of performing R&D activities.

Qualified expenses include:

- W2 wages paid to employees involved in the R&D activity
- Supplies (including tangible property, extraordinary utility costs, and server leasing costs) used for the R&D activity
- Contract R&D-related costs that would qualify if they were conducted by regular employees

Qualifying for the R&D Tax Credit: The Four Criteria

To qualify for the Research and Development (R&D) Tax Credit, your company's R&D activities must be conducted within the United States and must meet all of the following four criteria:

1. **Business component:** You must demonstrate that the information being discovered was to develop a new or improved product, process, technique, formula, or software for sale, lease, or license or that could be used to further the trade or business that your company is involved in.
2. **Technological in nature:** The R&D activities must involve the application of principles in hard sciences such as physics, biology, chemistry, engineering, or computer science.
3. **Process of experimentation:** Your R&D activities must follow a systematic process to evaluate one or more alternatives to achieve a result by. For example, trying different technologies, testing several iterations, or conducting modeling or simulation to achieve a unique or different outcome.
4. **Elimination of uncertainty:** The goal of your R&D activities is to eliminate uncertainty regarding capability, method of achieving the desired result, appropriate design, or the improvement of a process or product.



How the Research and Development (R&D) Tax Credit Is Calculated

The Research and Development (R&D) Tax Credit is the sum of the following:

- Regular credit or alternative simplified credit
 - Regular credit: Twenty percent (20%) of the excess qualified research expenses for the tax year over a base amount
 - Alternative simplified credit: Fourteen percent (14%) of the current year qualified expenses that exceed 50 percent of the average qualified research expenses for the previous three years
- University basic research credit equals 20 percent of the basic research payments determined under Section 41 of the IRS Code; and

- Twenty percent (20%) of the amounts paid or incurred by your business to a business that was organized and is operated primarily to conduct energy research

Research and development credits are “nonrefundable,” meaning they can reduce the amount of tax owed to zero but no further. In other words, if the credit exceeds the amount of business tax owed, your business won’t get money back from the government. However, if company’s total general business credit is more than the taxes it owes for the year, your business can carry the excess back for one year or forward for up to 20 years.

Pro Tip: If your business qualified for the Research and Development (R&D) Tax Credit but did not claim it in prior years, your CPA can amend the corporation’s past returns to claim your credit. Ask your CPA about a “look back” study to see if your business may qualify for such claims.



In addition, thanks to the 2015 Protecting Americans from Tax Hikes (PATH) Act, if your company has less than \$5 million in gross receipts but no taxable profit, you can claim up to \$250,000 of the credit against payroll taxes. This enables your small businesses to reap the benefits of the R&D tax credit even if you have no tax to offset – in other words, even if you didn’t generate a net profit!

Cashing in on Six Additional Benefits of the R&D Tax Credit

Tax savings are just one of the benefits of the R&D tax credit. This generous tax credit can also be used to drive innovation and growth in the following six ways:

1. **Increases cash flow:** Paying less in taxes leaves you with more capital to invest in improving and growing your business.
2. **Simplifies budgeting for innovation:** Thanks to changes in the tax code in recent years, the R&D tax credit can be very predictable, making it easier for businesses to budget for innovation. You don’t need to wait till the end of the year to see whether the credit is being offered this year.
3. **Sharpens your competitive edge:** Having more money to invest in the innovation of new products, processes, and technologies can enhance your competitive position in the marketplace.

- 4. Attracts investment:** By demonstrating your commitment to R&D and taking advantage of the R&D tax credit, you make your business a more attractive investment opportunity. You show not only that your business is committed to innovation but also that you know how to finance that innovation in a fiscally responsible way that conserves capital for additional R&D activities or other business needs.
- 5. Enhances your global position:** Savvy investing in R&D positions your business as a hub for innovation fueled by technology, which may lead to attracting international investment dollars and new employees.
- 6. Magnifies your environment and social impact:** If your R&D is targeted to specific environmental or societal goals, such as green energy or increasing diversity, equity, and inclusion (DEI), you can position your business more effectively as a sustainable and socially responsible organization.

Exclusions

According to the Internal Revenue Service (IRS), some research activities are excluded from qualified research under section 41(d)(4) of the IRS Code, including:

- Research conducted after the beginning of commercial production
- Activities relate to adapting an existing business component to a particular customer's requirement or need
- Reproduction an existing business component, in whole or in part, from a physical examination of the business component, plans, blueprints, detailed specifications, or publicly available information with respect to such component
- Efficiency surveys, routine data collection, and market research, testing, or development
- Any research conducted outside the United States, Puerto Rico, or any possession of the United States
- Research in the social sciences (*including economics, business management, and behavioral sciences, arts, or humanities*)



Claiming the R&D Tax Credit

Sole proprietorships, partnerships, and S-corporations can claim the R&D Tax Credit by filing Form 6765 (the *Credit for Increasing Research Activities Form*) with their business return. While qualifying small businesses can elect a payroll tax credit of up to \$250,000 instead, qualifying for the credit may not be as easy as it seems on its surface.

If you think that your business may qualify for the R&D tax credit, contact us at SWC and schedule a consultation. We can help you determine whether you qualify for this tax credit and help you estimate the tax savings you can expect, so you can make well-informed decisions when it comes to budgeting for innovation.

Disclaimer: *The information in this SWC Business Brief about The Credit For Increasing Research Activities (aka, the Research and Development (R&D) Tax Credit) is provided for general informational purposes only and may not reflect current financial thinking or practices. No information contained in this Business Brief should be construed as financial advice from the staff at SWC (Steas, Walker & Company, LLP), nor is the information contained in this Business Brief intended to be a substitute for financial counsel on any subject matter or intended to take the place of hiring a Certified Public Accountant in your jurisdiction. No reader of this Business Brief should act or refrain from acting on the basis of any information included in, or accessible through, this post without seeking the appropriate financial planning advice on the particular facts and circumstances at issue from a licensed financial professional in the recipient's state, country or other appropriate licensing jurisdiction.*



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