

The R&D Credit: Quantifying Your Credit



By Mark Dunning, Partner with TaxOps Minimization, LLC

Innovative research is one key to American prosperity, and the United States government recognizes it. Research and development leads to valuable intellectual property, capital investments, job creation, cutting edge products and services, and economic growth. To encourage innovation, the U.S. government offers corporate taxpayers engaged in technological development on U.S. soil a tax break in the form of a federal research and development (R&D) tax credit.¹

The R&D tax credit is not a deduction; it is an actual dollar-for-dollar credit against taxes owed or paid. The taxpayer may be able to expense all such qualifying R&D costs in the year incurred. The credit itself can return 4 to 6.5 cents for every dollar spent in qualified wages, supplies, or outside contractor expenses above a determined, taxpayer-specific base amount. As a result, a start-up software company with just over \$1 million in revenue could realize \$50,000 in R&D credits. A medical device company with \$300 million in revenue may receive well over \$1 million in R&D tax credits.

Federal research tax credits offset more than \$7.5 billion in R&D expenses at U.S. companies annually. Roughly one-fourth of all businesses that claim research credit have assets of less than \$1 million. Larger companies tend to make more claims than smaller companies because they are better informed about the credit and are more aggressive in pursuing it. Many small- to mid-size companies might not realize they qualify for the credit, or may be intimidated by the complexity of the rules, documentation requirements, and calculation mechanics governing the credit. Still others may lack the time, resources, or expertise necessary to identify and manage R&D credit claims. In truth, all but the smallest companies, where the cost of maintaining documentation may be prohibitive, could reduce the cost of labor-intensive R&D investments by taking advantage of the research credit.

With the U.S. deficit running at an all-time high and tax receipts flat, though, the IRS is taking a hard line on credit filings. An amended tax return or large R&D credit may trigger an IRS audit that could result in penalties against the corporate taxpayer or return preparer for any unwarranted claims. Corporate taxpayers must understand the ins and outs of R&D credit – eligibility, documentation, and filing requirements – before pursuing a line item almost certain to attract IRS attention.

¹ The availability and size of state R&D credits vary. Consult your local tax consultant for state-based R&D credit specifics.

Qualifying activities

To qualify for the credit, companies must be engaged in activities that are technological in nature and are directed at developing, or attempting to develop, a new or improved business component based on functionality, performance or quality. There must also be an experimentation process built around trial and error. Internal-use software development activities are qualified under additional criteria.

Companies that benefit from the research credit may be engaged in a variety of activities across U.S. business sectors, including the following.

- Aerospace
- Agriculture
- Biotechnology
- Chemical
- Electronics
- Energy
- Engineering
- Fabrication
- Food sciences/manufacturers
- Information and communication technology
- Machine shops
- Medical technology
- Pharmaceutical
- Plastics manufacturers
- Software developers
- Tool and die

Qualifying Expenses

Determining what are qualified expenses and what are not can be complex. The credit applies only to eligible expenses, known as “qualified research expenditures”, and includes in-house wages, supplies, and outside contract labor associated with qualified research that exceeds a determined, taxpayer-specific base amount of R&D spending. Prototype expenses may be included in some cases. Indirect costs such as overhead, travel, education, taxes, or capital expenditures are not included. According to the R&D Credit Coalition, more than 75 percent of credit dollars are earned on wages paid to people working in high-skilled, high-paying R&D jobs in the U.S.; in some industries, this figure is more than 90 percent.²

² R&D Credit Coalition, <http://www.investinamericasfuture.org/>.

Calculating the credit

R&D credits are calculated using one of two credit formulas: the traditional credit and the alternative simplified credit (ASC). Under the traditional formula, corporate taxpayers receive a 13 percent tax credit for qualified R&D expenses in excess of a calculated base amount. The base amount is determined by a statutory formula using the taxpayer's prior gross receipts and qualified research expenditures. The ASC method uses the taxpayer's historical (three prior years) R&D spending instead of gross receipts to calculate a credit.

Documentation Requirements

The recordkeeping and documentation requirements for the R&D credit are critical to justifying expenses to the IRS. Contemporaneous documentation must be maintained to support qualifying activities each year. Technical analysis should be completed before the return is filed. All workpapers and credit computations should be similarly documented and readily available for audit review. Additional documentation should include:

- ***Evidence of qualified activities.*** During an IRS audit, engineering experts may be sent in to confirm the qualified basis for the credits through a review of contemporaneous documentation around the credit calculation and other items the taxpayer used to justify eligibility for the credit claim.
- ***Evidence linking expenses to activities.*** The IRS is also interested in documentation that connects a company's qualifying expenditures and qualifying activities. For example, documentation should directly link the project to the employee and the time spent on that project for each specific year.
- ***Evidence that experimentation is taking place.*** Testing reports that identify the problem and testing outcomes should be maintained. Tests that result in product failures should be included as these efforts may demonstrate the cutting edge development taking place at a company.

Frequently Asked Questions

Is there any cap on the dollar amount of R&D credit?

There is no cap on U.S. research credits. Credits that cannot be used in the current period can be carried back one year and forward 20 years. Taxpayers may amend prior year returns to claim tax credits when the tax year is open for assessment of tax. Prior approval of projects or activities is not required.

Does the receipt of research funding disqualify a company from also receiving an R&D credit for the same project?

No. Companies that receive federal funding from a grant program can net the proceeds against expenses. Companies that receive compensation from a customer may also be able to claim all the expenses as a credit. The determining factors are that the company maintain rights to the intellectual property and be at risk for the costs.

Does claiming the research credit trigger an IRS Tier I audit?

If a taxpayer files an amended return and claims a refund due to a research credit, the company is likely to be subject to a Tier I coordinated audit. The audit is typically conducted by a local team under the supervision of the federal Tier I team. If the research credit is included in an original return and filed on time, the company may only be subject to a local audit. Anecdotal evidence suggests that local IRS agents are using Tier 1 information document requests and the Tier 1 framework for local IRS audits. So while an audit may not technically be subject to a Tier 1 review, the local audit team may act as if it is.

What if a company has a net operating loss?

The R&D credit is subordinate to net operating losses (NOLs) and alternative minimum tax (AMT) credits. Companies with NOLs deduct the losses first, and use any AMT credit next. After both items are used, the research credit can be applied against taxable income on a carryforward basis for up to 20 years. It is best to claim the credit on the originally filed return and use that credit when the company becomes taxable.

Can a company receive a cash benefit for research credit even though the company is not paying tax?

No. The research credit is not refundable for cash. The research credit is used against taxable income only net of NOL and the AMT.

What is the significance of the section 280C election on the credit?

Years ago, the research credit benefit was reduced by requiring taxpayers to add back into income the amount of the credit in the year the credit was generated. A separate option was introduced allowing companies to take a “reduced credit” or in other words elect to file 280C. The 280C election was designed to have the same net benefit with fewer administrative hurdles. The 280C reduction election must be made on an original, timely filed tax return. This election cannot be made on an amended return. Once made, the election is irrevocable. AMT implications must be considered when making the election.

Can the R&D credit be estimated?

No. Companies must take the time to document and support the research activities and to quantify the credit. Companies that simply estimate the credit in their tax return risk disallowance of the credit entirely as well as penalties that can amount to up to 20 percent of the credit claimed by the taxpayer (IRC Section 6662).

As a tax return preparer, can I take the R&D department wages, direct supplies, and outside contract research expenses off the general ledger and calculate the R&D credit for the taxpayer?

No. A proper and documented R&D credit determination must be made. Return preparer penalties for improperly reported research credits under IRC Section 6694 can amount to \$1,000 or 50 percent of the credits claimed, whichever is greater.

What is the future of the R&D credit?

The research tax credit has been extended 14 times since first introduced by Congress in 1981. To keep R&D activities in the U.S., Congress is looking at making the research credit permanent, which would give companies that invest in R&D more certainty for realizing additional tax savings in future years. A number of other countries already provide permanent R&D credits – some of which have larger benefits than the U.S. – including Australia, Canada, France, India, Indonesia, Ireland, Japan, the Netherlands, Pakistan, Portugal, Singapore, Spain, the U.K., and others.

About the Author

Mark Dunning is the managing partner of TaxOps Minimization, where he leads an experienced team in implementing tax-saving projects. He has developed deep technical knowledge of the research credit across all industries, including automotive, engineering, medical, manufacturing and software. Mr. Dunning has been responsible for the coordination, management and execution of some of the largest research credit studies performed by Ernst & Young. His work with small and mid-size companies has made him well-versed with the R&D issues they face as well. He consults regularly with clients on income tax accounting issues regarding the research credit.

Mr. Dunning is an accomplished negotiator with the IRS and has built a positive rapport with field agents and tax authorities across the country. He managed four of the 23 Pre-Filing Agreement (PFA) projects granted and closed by the IRS in the research credit area. He has also consulted and closed on several IRS and state audit and appeals

cases, including the successful completion of two IRS research credit record-keeping agreement projects.

Mr. Dunning began his professional career with Ernst and Young in tax compliance and provision preparation. Shortly thereafter, he shifted his focus to exclusively work with research credit and multi-disciplinary tax reduction projects, including domestic production deductions (section 199), uniform capitalization calculations, cost segregation and other federal and state credits. He left his position as an executive director at Ernst and Young to join TaxOps Minimization in 2010.

Mr. Dunning is a graduate of Brigham Young University, where he received a Bachelor of Science in Accounting and a Master of Accountancy in Taxation in 1994. He is a Certified Public Accountant and a member of the American Institute of Certified Public Accountants. He frequently writes and speaks about tax credit, deduction and deferral issues, and can be reached at 720-227-0420 or mdunning@taxops.com.



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Pre-qualification Questionnaire

Submit questionnaire to info@taxops.com, subject line, "Quantifying R&D."

Call us at 720.227.0070 to connect with an R&D professional.

TaxOps Minimization can assist in qualifying and quantifying R&D credit. Please complete the following questionnaire and submit to receive an estimate from the TaxOps Min Team of the potential size of R&D credit your business may be able to claim.

	YES	NO
Is the company currently engaged or planning to engage in the technical development of a new product or process?		
Does the company have consistent or incremental spending, such as wages, supplies, or outside contract expenses, for research in the development of a new product or process?		
If no, the company may not qualify for R&D credit. Please contact a TaxOps representative if you have further questions.		
Are you engaged in any of the following industries or activities? You may select more than one:		
Aerospace		
Agriculture		
Apparel/textiles		
Architects		
Automotive		
Chemical		
Computer hardware or software		
Design manufacturing		
Electronics		
Energy		
Engineering		
Fabricators (steel, plastic, wood)		
Food products or food processing		
Life sciences		
Medical devices		
Oil and gas		
Pharmaceuticals		
Software development		
Technology companies		
Telecommunications		
Tool & die shops		
Other [please specify]		

	Explain if Applicable
Does your company own any patents or develop any patentable activities?	
How many full-time equivalent engineers or developers are on staff?	
Is the number of engineers growing or declining?	
What are the average wages of staff engineers?	