

A BUSINESS OWNER'S GUIDE TO R&D TAX CREDITS

Don't miss an opportunity to improve
your cash position.



WIPFLI

You don't need an expensive laboratory or a Fortune 500 budget to take advantage of research and development (R&D) incentives offered by the IRS and many states. Many companies don't know that — and so they miss out on massive opportunities to boost their cash positions.

Don't leave money on the table. Use this guide to identify R&D tax credit opportunities and learn how to apply the credits correctly.



Table of contents

| | |
|--------------------------------------|----|
| What is the R&D tax credit? | 4 |
| R&D tax credit myths | 5 |
| Eligible activities and expenses | 7 |
| How to calculate your R&D tax credit | 11 |
| How to claim the R&D tax credit | 13 |

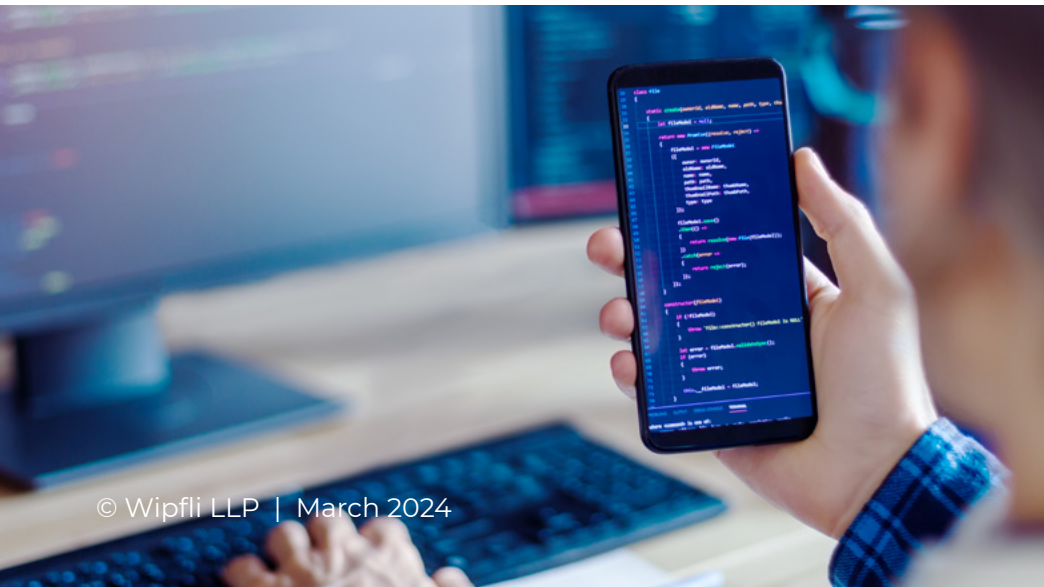
WHAT IS THE R&D TAX CREDIT?

The R&D tax credit was created in 1981 to encourage companies to invest in innovations that lead to sustained job growth. The idea was to reward companies for taking risks to invent new technologies and processes, assuming the long-term benefits would enrich the economy as a whole.

The credit has remained part of the tax code ever since, including numerous extensions and revisions under both Republican and Democratic administrations. Eligibility criteria and how the credit is applied have shifted along with changes in the tax code, but the tax credit was made permanent under the PATH Act of 2015.

The credit is known by several names, but they all refer to the incentive defined in [Internal Revenue Code \(IRC\) Section 41](#):

- The research and development (R&D) tax credit
- The research and experimentation (R&E) tax credit
- The research tax credit
- The credit for increasing research activities



R&D TAX CREDIT MYTHS

When you consider the complexity of the tax code, it's no surprise there are a lot of misunderstandings surrounding the R&D tax credit. You may have heard that:

- Only large businesses are eligible.
 TRUE FALSE
- You need a big research budget and costly dedicated facilities to qualify.
 TRUE FALSE
- You can't claim the credit without a successful breakthrough discovery.
 TRUE FALSE
- Supporting documentation is difficult to come by.
 TRUE FALSE
- The credit only benefits you for the current tax year.
 TRUE FALSE

The truth about R&D tax credits

The truth is, to be eligible for a credit, the outcome of the activity does not have to result in something new to the industry – it just has to be new for your company. Your innovation attempts don't have to be successful in the year you apply, either.

Businesses of all sizes may qualify. If your business creates new processes or products, enhances existing ones, builds custom machinery, or develops or adds value to software, then there's a good chance you can qualify for a federal or state R&D tax credit.

The credit applies to a surprisingly wide number of industries. And qualifying is simpler than you might think.



ELIGIBLE INDUSTRIES

The name of the tax credit causes some people to assume it's only available to scientific firms. Not true.

The R&D tax credit has been successfully received by to small- and medium-sized businesses and startups in:

- Engineering
- Software development
- Custom machinery
- Plastic injection molding
- Tool and die making
- Automation

ELIGIBLE ACTIVITIES AND EXPENSES

Activities that are eligible for the R&D tax credit

To qualify for the R&D tax credit, activities must pass a four-part IRS test. They must:

1. Attempt to develop or improve something fundamental to your business.
2. Address an essential technological uncertainty.
3. Be subject to measurement by a hard science.
4. Follow a documented process of experimentation.

Expenses that are eligible for the R&D tax credit

The tax credit rules allow you to claim labor, supplies or outsourcing costs, depending on conditions outlined in the corresponding [IRS and Treasury codes](#). In addition, all work must be performed inside the U.S.

Examples of qualifying expenses include:

- Taxable wages paid to employees who directly contribute to qualified research activities.
- Taxable wages paid to people who directly assist those employees.
- Taxable wages paid to people who directly supervise those employees.
- 65% of payments to contractors who perform direct services in the U.S. in support of such work.
- Payments to vendors who supply materials used in the conduct of research.

It's important to keep detailed records. Most of the documentation you need is likely captured in existing business documentation.

This might include:

- Project budgets, schedules and progress notes.
- Detailed employee assignment and payroll records.
- Experimentation logs and observation notes.
- Supply inventories, purchase orders, receipts and other procurement documents.
- Contractor bids, proposals and scope documentation.



INELIGIBLE EXPENSES

Some expenses are unambiguously out of bounds for R&D tax credit qualification. These activities do not qualify for an R&D tax credit:

- Benchmarking or reverse-engineering competitors' products
- Training efforts and costs
- Market or consumer preference research
- Research conducted outside the U.S.
- Routine quality control testing on existing products or processes
- Travel expenses



HOW IS THE R&D TAX CREDIT CALCULATED?

The credit is calculated primarily based on wages paid to employees who engage in a qualified research or experimental activity and the value of the resources and supplies they use. Wages are a major expense for most companies, so it's easy to see how a credit based on payroll could significantly reduce your tax burden.





How to calculate your R&D tax credit

Once you've decided to pursue the R&D tax credit, there are two ways to perform the calculations:

- 1.** The regular research credit method determines a historic ratio of qualified research to gross receipts. Your current-year qualified research costs must exceed the historic ratio, when applied to present gross receipts, to generate a credit.
- 2.** The alternative simplified credit method compares the amount that qualified research expenses (QREs) exceed 50% of the average for your three previous tax years.

Calculate and report the credit on [IRS Form 6765](#) and submit it with your company's tax return.

How to choose the right calculation method

The calculation method that yields the maximum tax benefit depends on your business circumstances. Fortunately, you can change your election from year to year, if you file on time and don't amend your return.

Tax circumstances can shift significantly along with business conditions, so it's best practice to evaluate both options for every tax year. You may also qualify for state credits depending on the state where the research is performed.

Regardless of the calculation method you choose, the resulting credit can have a worthwhile impact on your company's tax position. The payback is certainly worth getting the documentation in order.





HOW TO CLAIM THE R&D TAX CREDIT

To claim the R&D tax credit, file [IRS Form 6765](#) with your company's tax return. On the form, the credit is referred to as the Credit for Increasing Research Activities.

When you file the R&D tax credit claim, you'll need documentation to support all aspects of your credit. These include:

- Business component (project) listing and documentation to support how each meets the four-part test.
- Nexus documentation, which supports the connection of all qualified research costs to business components.
- The wages you paid to employees who were directly involved in qualified research activities.
- The cost of supplies used in the conduct of qualified research activities during qualified research activities.
- The cost of qualified research activities performed by third-party contractors.

Repeat this process every year

There are several reasons why it makes sense to evaluate the R&D tax credit every year:

1. Companies that compute the credit on their own often overlook valid expenses they can claim or underestimate their QREs. Completing an accurate analysis is easier during or immediately after the end of the year, while the details of qualified activities are fresh in everyone's mind.
2. You can change your calculation method each year, but you must do so on the originally filed return. The calculation method cannot be changed on an amended return.
3. Business processes change from year to year, so it makes sense to analyze the R&D tax credit annually.



REMEMBER

- Unused credits can be carried back one year or forward 20 years.
- The credit is intended to incentivize U.S.-based innovation. There's no requirement for your innovation attempts to fail, succeed or result in something new to the world.

IS YOUR BUSINESS ELIGIBLE FOR THE R&D TAX CREDIT?

Tax law is complex, and many activities that aren't traditionally R&D oriented actually qualify for credits at the state and federal levels.

Wipfli's research and development tax credit team knows where to look for activities that qualify and how to get it done with a minimally intrusive process — helping your business lower your tax liability and increase your cash flow.

Let us help you evaluate your options, check for federal and state eligibility, and prepare a personalized strategy to maximize your benefits from the credit — possibly for multiple tax years. Contact us today to learn more.

wipfli.com/tax-credits



WIPFLI