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# Research and Development Tax Credits



To remain competitive in today's market, a business must innovate or become obsolete. The challenge is that the research activities to remain at the forefront of a market can be time-consuming and costly. Fortunately, Congress created an incentive to support U.S. businesses with their research and development: [The Research and Development Tax Credit](#).

## History of the R&D Tax Credit

The credit was first introduced in 1981 as a two-year incentive for businesses to undertake risky innovation – to keep U.S. businesses competitive in an increasingly global market. In the early years of the credit, however, startups and small businesses were often left out – unable to use the credit and therefore compete with the types of bigger corporations that have dedicated research teams.

In 2015, the PATH (Protecting Americans from Tax Hikes) Act permanently extended (and expanded) the credit to better support small businesses. Businesses with less than \$50 million in average gross receipts could finally claim the R&D credit against their Alternative Minimum Tax (AMT). The PATH Act also permitted companies with less than five years of gross receipts to qualify for up to \$1.25 million in R&D credits to offset the FICA portion of their annual payroll taxes.

The 2015 changes have been lauded as leveling the playing field for new and smaller businesses that also want to innovate.

## Who Can Claim an R&D Tax Credit?

The Credit is available to any US business that incurs expenses while attempting to develop new or improved products or processes while in the United States. It's important to point out that expenses incurred when improving upon business performance and functionality can be qualifying R&D expenses.

The IRS created a four-part test to determine if your business and activity qualifies for the credit.

First, the R&D must be conducted with the purpose of eliminating uncertainty about the product. Research and development for aesthetic purposes does not qualify for the tax credit.

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

Third, the activities must be based on science or engineering. Computer science, biology, chemistry, and other "hard" sciences qualify.

Finally, the purpose of the activity must be to create a new or improved product or process, resulting in increased function, reliability, performance, or quality.

## What Activities are Excluded from the R&D Credit?

Knowing which activities do not qualify for the credit is just as important as knowing the activities that can be claimed. Unfortunately, there are many business expenses (that may seem like R&D) that do not actually qualify for the tax credit. Claiming expenses for un-qualified activities could land your business in hot water, so they are definitely worth noting.

Here are some activities that cannot be claimed for the R&D Tax Credit:

- Research conducted after the beginning of commercial production
- Research adapting an existing product or process to a particular customer's need
- Duplication of an existing product or process
- Surveys or studies
- Research relating to certain internal-use computer software
- Research conducted outside of the United States, Puerto Rico, or a U.S. possession
- Research in the social sciences, arts, or humanities
- Research funded by another person or governmental entity

## What Expenses Qualify for the Credit?

If your business undertakes qualified R&D activities, you can typically claim a credit for qualified expenses which include:

- Wages paid to employees engaged in the R&D process
- Supplies used in the R&D process
- Expenses paid to third-party contractors in the US for performing research on behalf of your business

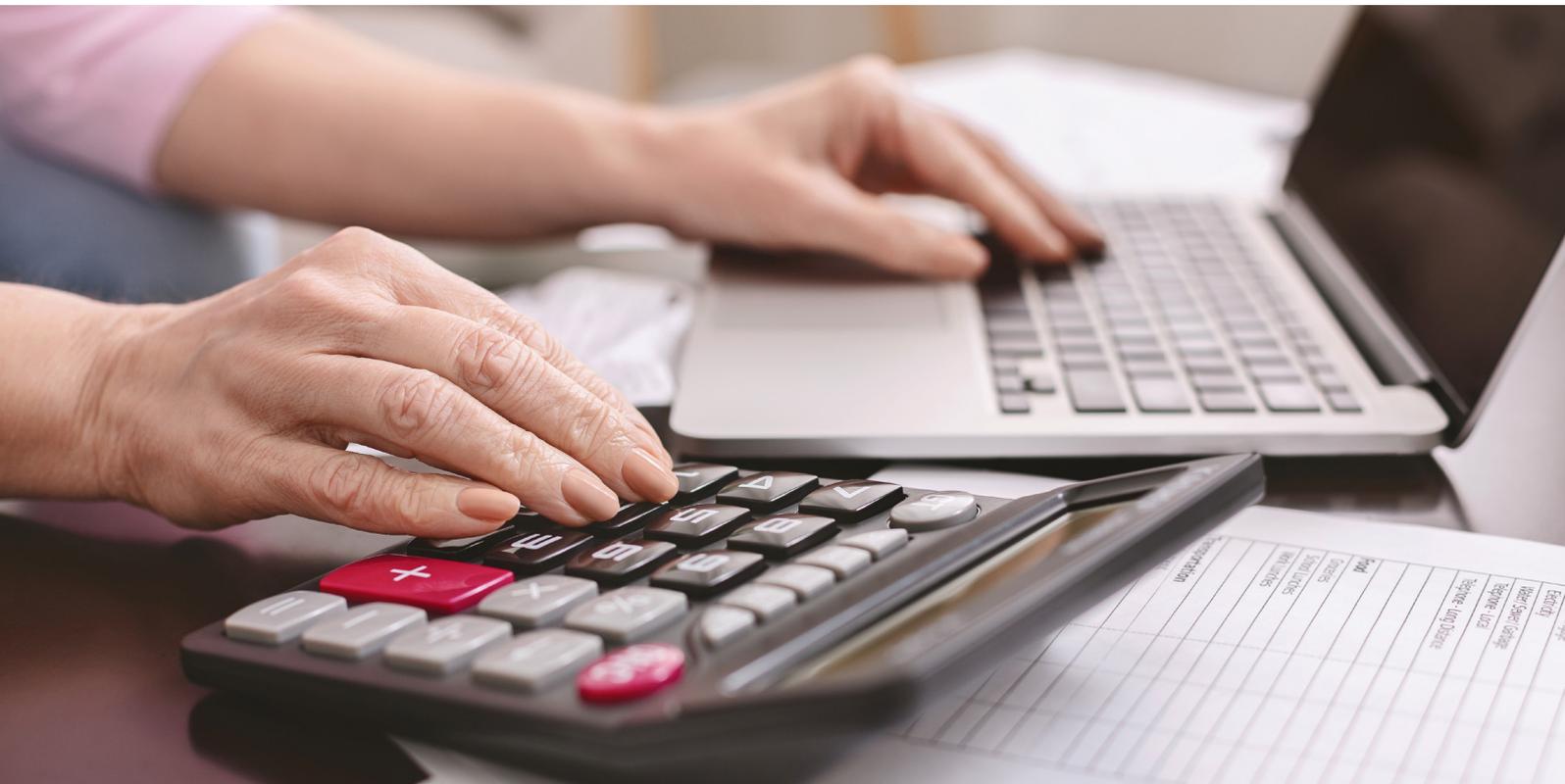
## How is the R&D Tax Credit Calculated?

Once you determine which R&D activities are actually qualified, calculating the credit gets much simpler. It is important to remember the credit is for increases in research activities, so your expenses must exceed a base amount.

There are two methods to calculating the research and development tax credit amount. With the traditional method, you determine a base amount based on revenue and expenditures over the past four years. Any research you undertake that exceeds base amount qualifies for a 20% credit.

With the Alternative Simplified Credit method, you can follow a four step calculation to arrive at the tax credit.

The rules and calculations for both methods can be complex so it's best to consult with us on calculating the credit.



## Claiming the Credit

The Research and Development Credit can be claimed for current and prior tax years as long as you maintain appropriate documentation. You can also carry the credit forward for up to 20 years.

Under the Protecting Americans from Tax Hike Act of 2015, also known as the Path Act, new and small businesses can apply up to \$250,000 of their research and development tax credit against their FICA payroll tax each year, for up to five years. To qualify, your business must have no more than 5 years of gross receipts and less than \$5 million of revenue. This can be very beneficial to businesses that are not profitable and don't have income tax.

The PATH Act also allows businesses that are not publicly traded and have an average of \$50 million or less in annual revenue over the past three years to use the research and development tax credit against the alternative minimum tax, or AMT.

## Next Steps

Our firm can help you determine if your business can benefit from the Research & Development Tax Credit. We will help you identify possible qualifying expenses and compile the information needed to substantiate your claim. Contact our office for more information.



## About Your Firm LLC

We have hand-picked a team with tax, auditing, accounting, business and management advisory expertise in a multitude of fields, including healthcare, professional-services firms, commercial contractors, home builders, real estate companies, manufacturing and distribution companies, dealerships, non-profit organizations and pension funds.

We have the expertise and the resources to provide not only the critical services you need during these evolving economic times, but also, importantly, to build for the future. Our strategic alliances with professional organizations across the country allow us to bring our clients the talent and expertise of national firms with the high-touch service of a local firm. While we remain focused on the core services of tax, accounting and audit, we expand and offer you the business consulting needed to remain competitive. We believe the success of our clients is the greatest measure of our own.



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