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An Informed Guide to R&D Tax Credits



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What Are R&D Tax Credits?

Did you know that research and development (R&D) tax credits can reimburse you for keeping the U.S. competitive? As general business tax credits created under Internal Revenue Code Section 41, they're federal and state tax incentives intended to stimulate innovation, technical design, and product development and enhancement; they keep the U.S. a leader in innovation. By reimbursing companies that develop new products, processes, or inventions, they can offer up to 10 percent back to your company for qualified research activities and expenses. Over 40 states in the U.S. offer a state-level tax credit as well.



Which States Offer R&D Tax Credits?

Thanks to R&D tax credits, companies can win tax savings, improve their cash flow, and stay competitive in the marketplace. Although many qualifying activities are considered day-to-day operations in many industries, less than one-third of eligible companies know they qualify for the credit. Is yours one of them?

Think of the R&D tax credit as a potential treasure chest. It can provide a hidden but immediate source of cash for you from prior years, while significantly reducing your current and future year's federal and state tax liabilities.

Today the R&D tax credit has four separate components

- 1. The Regular Credit
- 2. The Alternative Simplified Credit
- 3. The Energy Research Credit
- 4. The Basic (or University) Research Credit

In any taxable year, taxpayers can take advantage of any or all these kinds of the credit.

When is the best time to have an R&D tax credit study done? If possible, have your study completed well in advance of your March 15/April 15 or September 15/ October 15 tax filing deadline.

But what happens when tax deadlines have come and gone, and your business failed to claim the R&D tax credit? No worries – you can still file your claim for the credit with an amended return.

Good news: You can capture your R&D tax credits for the current tax year and for the prior three open tax years. If you have performed qualifying activities in the past, this could be a substantial credit for your business. As we mentioned before, you can also submit tax credits for projects that didn't succeed—not just the ones that worked out.

Next: Why is the R&D Tax Credit Important?



Why Are R&D Tax Credits Important?

Here's the imperative situation: the U.S. is losing high-paying jobs tied to manufacturing and innovation to competitive overseas markets. The R&D tax credit is one of our country's best defenses to try to stem this loss. This is because the R&D tax credit is, in reality, a jobs credit—a wage credit—that incentivizes businesses to create and keep high-paying and strategically important jobs in the U.S. that help us maintain our competitive edge in next-generation design, manufacturing, technology, and medical breakthroughs.

Technologically skilled employees are a vital part of this R&D industry and our economy overall – they comprise the middle class that earns \$100,000-150,000 a year and are critical to the success of our country's goals to stay competitive with other nations. The R&D credit is essential to keeping this workforce in the U.S.



This is particularly important as the U.S. faces steep competition for this field of experts. As **this 2020 Ernst & Young study** demonstrates, many other countries have better, more lucrative R&D tax incentives than the U.S. Several countries have gone so far as to introduce what is known as a patent box, a special very low corporate tax system that incentivizes research and development by taxing patent revenues differently from other commercial revenues.

America's strong economy depends on two primary factors: access to capital markets and a strong workforce. That's why we have such a high standard of living. But capital markets are under stress now, particularly if the U.S. dollar isn't backed by high-paying jobs generating income tax. And if you drive away strategic jobs in the \$100-150k wage range, our economy will suffer.

Next: How Did R&D Tax Credits Originate?





A History of R&D Tax Credits

In the late 1970s and early 1980s, American companies were being overwhelmed by Japanese competition; U.S. car companies were rapidly losing market share to Japanese car manufacturers because of perceived superior reliability, and highquality Japanese electronics quickly became the TVs and gadgets of choice, leaving American-made products in the dust.

But American lawmakers took note of the fact that this technological superiority was directly the result of the fact that the Japanese government directly subsidizes Japanese industry through the <u>Ministry of International Trade and Industry</u> (MITI), financing research and development and providing many other economic advantages. U.S. politicians wisely decided it was time to start helping American industry and enterprise compete in the global arena by creating a tax credit that rewarded technical research and innovation.



Senator Bill Roth and Representative Jack Kemp, the creators of the R&D tax credit

In 1981, Congress created the R&D tax credit, formally known as the Credit for Increasing Research Activities, when it passed in the **Economic Recovery Tax Act of 1981**, which was sponsored by Senator William Roth and Representative Jack Kemp. Although the credit was created as a temporary measure, destined to expire on December 31, 1985, it extended as part of the Tax Reform Act of 1986. In the decades to come, it was so popular that while it expired eight times, it was extended 15 times. Before 2003, you could only win the credit if you created or produced a product or process that was new to the world. This was known as the Discovery Rule. Eliminating the Discovery Rule was first proposed in 2001 because it was so restrictive. In 2003, the Discovery Rule was replaced by the requirement that instead of being new to the world, research now only had to be towards creating or producing a product or process new to the taxpayer. As a result, the barrier to qualification was lowered, and the credit became available to wider set of enterprises.



In 2006, because the Alternative Simplified Credit (ASC) was enacted, businesses could be more flexible in calculating credit amounts, and they could alter the credit's baseline calculations.

At the end of 2015, the Protecting Americans from Tax Hikes Act (PATH Act) passed, officially making the R&D tax credit a permanent fixture of the U.S. tax code. Because the AMT (Alternative Minimum Tax) turn-off was enabled for businesses with \$50 million or less in gross receipts, the pool of companies eligible to benefit from the credit greatly increased.

In 2018, the Tax Cuts and Jobs Act made R&D tax credits even more attractive by relaxing AMT restrictions for S-corps and C-corps.

On September 17, 2021, the IRS Office of the General Council released a **memorandum** that outlined stringent new reporting rules that went into effect January 10, 2022.



In addition, under current law, firms must amortize R&D costs over five years beginning in 2022.



The Four-Part Test

The Four-Part Test

The IRS requires that your R&D activities meet this four-part test:

Permitted Purpose

Research activities must relate to new or improved business components, function, performance, reliability, and quality.

2

Technological in Nature

Research activities performed must fundamentally rely on principles of physical or biological science, engineering, or computer science.



Elimination of Uncertainty

Research activities must be intended to discover information to eliminate uncertainty concerning the capability, method, or design for developing or improving a product or process.

4

Process of Experimentation

The taxpayer must engage in an evaluative process that can identify and evaluate more than one alternative to achieve a result. This may include modeling, simulation, or a systematic trial-and-error methodology.

What activities aren't viewed by the IRS as qualified research?

- Adapting existing business components;
- Duplicating existing business components;
- Foreign research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States;
- Research conducted after the beginning of a business component's commercial production;
- Research related to social sciences, arts, or humanities;
- Research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity);
- Reverse engineering;
- Software developed for internal use, except software that the taxpayer develops for selling and general and administrative expenses; it must be limited to financial management, human resources management, and support service (see Chapter 6);
- Surveys, studies, activity relating to management function/technique, market research, routine data collection, or routine testing/quality control.



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Special Rules for R&D Tax Credits for Startups Research and development (R&D) tax credits can be ideal for startups particularly those of a technical nature, such as in the fields of computer science or pharmaceuticals. The credits have the potential to deliver a financial windfall to qualifying taxpayers; for example, they can offset up to \$250,000 of their FICA payroll tax for their first five taxable years.

But there are also challenges to be considered, because of the unique circumstances of startups. This makes it wise to partner with a specialty tax firm like **Engineered Tax Services** well-versed in applying for, and winning, the credit for its clients. You'll understand as we delve into the complexity of the IRS rules surrounding startups later in this chapter.

\$250,000 in Payroll Offset

Thanks to the PATH Act of 2015, which made the federal R&D tax credit<u>permanent</u>, <u>startups can now use the credit</u>—even if they're not paying federal income tax—to offset up to \$250,000 of their <u>FICA payroll tax</u> for their first five taxable years, if they have gross receipts less than \$5 million in the tax credit year; zero gross receipts for any taxable year preceding the five-taxable-year period ending with the tax credit year; and R&D credits of up to \$250,000 that they can utilize in that year.

Startups and Business Tax Credits Limitation Rules

The size of a company's R&D tax credit depends on the dollar amount of its Qualified Research Expenses (QRE). QREs can include wages, contractor costs, and supply costs, but without question, wage QREs are the vast majority of most taxpayers' QREs. However, Section 38 of the IRS tax code limits the amount of the tax credit to the amount of the taxpayer's tax liability over \$25,000. If startup has little or no income or currentyear tax liability, it may not be able to get an



immediate benefit from the R&D tax credit. Yes, the startup will have unused R&D tax credit carryforwards, but it can only employ those carryforwards if the business is profitable, when potentially it will have less of a financial need for an R&D tax credit.

Startups and Fixed-Base Percentage Rules

The IRS' fixed-base percentage rules can either help or hinder startups. The fixedbase percentage measures the taxpayer's increase in spending. For older or historic companies, it's the product of the average of the taxpayer's gross receipts for the prior four tax years and the average of its QREs for the same years. But for startups, there's a fixed-base percentage at 3% for the first five years, and then a percentage of the gross receipts and QREs for later tax years. A maximum fixed-base percentage of 16% could make it much more difficult for a taxpayer to take a R&D tax credit, while a fixed-base percentage of 1% or less will usually result in the taxpayer winning the credit; a 3% fixed-base can go either way. As a result, the statutory 3% fixed-base percentage can help some startups qualify for the R&D tax credit.



But sometimes the IRS' base amount limitation rules get in the way of startups. The base amount limitation rules restrict the amount of the taxpayer's current tax year QREs that are counted, to whichever is lesser: (1) the taxpayer's total QREs for the current year minus its base amount, or (2) one-half of the taxpayer's total QREs for the current year. The credit will almost always be larger under the first option instead of the second. Because the low statutory fixed-base percentage for startups is only factored into option one and not option two, the base amount limitation usually forces startups to compute their tax credits using the less favorable second option. This can significantly reduce the amount of credit available to startups, and it can even prevent startups from being able to take a tax credit.

Startups and Alternative Simplified Credit Rules

If taxpayers can't qualify for the credit using fixed-base percentage rules, the alternative simplified credit (ASC) rules offer a viable alternative by providing a simplified method for computing the R&D tax credit. Since it compares the taxpayer's QREs for their current tax year to their QREs for their prior three tax years, the prior three years are the base period tax years, instead of the historic or start-up company base period tax years described above.

In addition, the IRS Code includes a base period limitation for the ASC. If the taxpayer lacks QREs for any one of the prior three tax years, their ASC is computed as 6% of their current tax year QREs. This limits the amount of ASC available to startup companies that have not been in existence for more than three tax years.



Startups and Contract Expense Rules

Startups should also be aware of the contract expense rules, which limits QREs for amounts paid to contractors to 65% of the amounts spent, designed to encourage taxpayers to use their in-house staff to perform research activities. However, many startups use independent contractors or temporary workers, hoping to hire the contractors as employees once they can pay the workers a regular salary. Because of the contract expense rules, startups can only claim 65% of the salary of contractors, as opposed to 100% for full-time employees.



Startups and Stock Option QRE Rules

Since many startups lack immediate access to capital, they instead use stock options to compensate employees and to attract and retain skilled workers. Startups defer counting the options as QREs for their R&D tax credits until the employees exercise the options, which can be years or even decades in the future. Otherwise, the options are never exercised, which happens if the company eventually fails. Because many startups pay employees and contractors with stock options in place of actual wages, this delayed inclusion of stock options as QREs can significantly limit the benefit that startups realize from the R&D tax credit.

It's Complicated

R&D tax credits can serve as a serious financial boon for startups of all varieties. But as you can see from this chapter's survey, the IRS has imposed a set of sometimes bewildering complexities on startups regarding the credit. As a result, it's wise to consult an experienced tax advisor like <u>Engineered Tax Services</u>, which is familiar with navigating R&D tax credit claims through the IRS minefield. We're happy to provide a free, no-obligation consultation to see how much money you could potentially save by filing.



Special Rules for R&D Tax Credits for Software Development and Gaming



The IRS places all software (including gaming software) into one of two categories:

- 1. external use, or third-party, software and
- **2.** internal use software.

Each is judged according to different criteria.

External Software Criteria

An excellent example of external software is Microsoft. External software is intended for sale, lease, or license to customers. The IRS will accept the credit if the research passes the four-part test (see Chapter 4).

The IRS applies the four-part test to each business component—that is, each individual software version or module developed. Here are some examples of external-use software applications that may qualify:

- document management systems;
- educational software;
- marketing software;
- firmware

Internal Software Criteria

Internal use software is devised to support a business internally. It can be used for administrative, financial, or HR management purposes or to accomplish support services within a business. Companies develop internal use software, based on their own platform, so they can be more capable operationally or to avoid paying a fee to a third-party vendor.

However, internal software must meet more stringent requirements. It must be highly innovative, and there can't be anything like it in the marketplace. (External use software doesn't have that requirement, because it's based on an original platform.)

> Internal use software must meet not only the four-part research test above, but also a heightened three-part test:

- **1.** The software must be highly innovative.
- **2.** Its development must introduce significant economic risk.
- **3.** A similar product must not be available commercially.

To determine the presence of significant economic risk, the internal software must pass an additional two-part test.

- **1.** Your company must commit significant resources.
- **2.** Substantial uncertainty must be involved. Can the R&D investment be recouped within a reasonable amount of time?

During the <u>seven main phases of the Software Development Lifecycle</u> (SDLC), it's the fourth — development and coding — where R&D tax credits are the most applicable. This is when the major project deliverables are built, and programmers, network engineers, database developers, and others create code to meet requirements and specifications within the required technical environment. Next comes quality assurance and user acceptance criteria, and finally unit testing is conducted to ensure all user and business needs are met.



Potentially qualifying activities include:

- Iterations of source coding;
- Iterations of algorithm development;
- Alpha testing;
- Beta testing (if it's necessary to go back to incorporate feedback and develop additional source coding for functionality, performance, or quality);
- Technical, environmental, system, and program documentation;
- Supervisors' and managers' time involved in leading, directing, and coaching the staff performing qualifying activities;
- Application and platform design and testing;
- Coding, programming, testing (such as for functional, integration, or user interface purposes);
- Developmental cloud computing activities;
- New architectures, new algorithms, or new database management techniques;
- Software and hardware product development to further communication and interaction;
- Specialized technology design (such as for image processing, artificial intelligence, or speech recognition);
- System software development (for example, operating systems or compilers).

However, the development of user/help documentation during this phase doesn't qualify.

Qualified Research Expenditures

Qualified Research Expenditures (QRE) are expenses judged by the IRS as acceptable for the credit. **They include:**

- wages of the employees who carry out the R&D;
- the supplies used during the R&D process;
- a portion of the wages of contractors hired to further R&D activity.

Expenses could include cloud computing costs and costs associated with offsite servers.

It's important to note that the R&D tax credit is primarily a wage-driven credit. The lion's share of R&D expenses is derived from the cost of paying eligible employees and consultants. However, for the purposes of applying for the R&D tax credit, all employees and consultants must be based in U.S., not India or another outsourcing location.



A few other points:

- Funded research is disqualified.
- If you are also claiming the Employee Retention Credit, that can reduce the amount of the credit you might be entitled to, because the ERC reduces wage costs.
- In addition, you must own the intellectual property rights to the platform you're constructing.



Above all else, documentation is key.

You must have substantiation to defend the credit and support it when you go to file. You should:

- Track the list of projects or revisions.
 Each version of the release would be a new project.
- Keep a list of projects and what your staff is working on.
- Have time tracking in place.
- Include employee titles.

Potentially qualifying R&D job titles could include:

- Director of Software Engineering;
- Programmer;
- Senior technical leads;
- Software analyst;
- Software developers;
- Software integration engineers.

Keep Clear and Accurate Time-Accounting Documentation

It's vital to keep clear and accurate time-accounting documentation, because 95% of qualifying R&D expenses for software relate to employee wages and U.S.based contractor fees. To properly claim R&D tax credits, you need to know exactly how much time is spent working on qualifying activities. List each project, all staff involved, and every hour spent on each qualifying activity.



Your documentation must prove:

- The project qualifies for the credit. There must be a risk involved that you undertook for the IP rights; for instance, a "time and materials project" does not qualify.
- The activities qualify. Do your activities pass each part of the Four-Part Test? (See Chapter 4.)
- The amount qualifies. The monetary amount you are requesting must be accurate.



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How Engineered Tax Services Can Help



If you're interested in using R&D tax credits as a financial solution for your company, you may be wondering: How do I start the process? Who should I contact?

To get a R&D tax credit study, only rely on a specialized company with both engineering and accounting capabilities that can undertake a full-fledged technical study.

As a licensed engineering firm that focuses on federal, state, and local tax benefits, Engineered Tax Services is an expert at R&D tax credit studies. Over the past 20 years, we've saved clients many, many millions of dollars. In fact, we recently saved a California software company a whopping \$1.5 million in tax savings. What could we do for you?

Contact us today for a free R&D tax credit analysis, and let us show you how much we can save you in taxes.

Click Here to Start.



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