

DEDUCTIONS AND CREDITS

Powerful Ideas:
Tax Benefits of Research
and Development



Tax Benefits of Research and Development

Research and Development Credits – In General

The Credit for Increasing Research Activities (Internal Revenue Code §41), commonly referred to as the Research and Development (R&D) or Research and Experimentation (R&E) tax credit, is a federal benefit that provides companies dollar-for-dollar cash savings for performing activities related to the development, design, or improvement of products, processes, formulas, or software. The credit amount is generally 20 percent of qualifying expenses that exceed a specified base amount. The base amount is computed based on the taxpayer's prior qualified expenditures and gross receipts. This credit was made permanent by the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) in December 2015.

The research tax credit rewards taxpayers with a credit for engaging in qualified research activities (QRAs) by providing a credit for a portion of their qualified research expenditures (QREs) incurred in these activities. Historically, the IRS has supported domestic research and development activities by allowing manufacturers and other businesses to expense certain costs immediately while also taking advantage of the R&D tax credit. The Tax Cuts and Jobs Act (TCJA), enacted in 2017, ended taxpayers' abilities to expense R&D costs as incurred beginning in 2022. Research expenditures must now be capitalized and amortized over a five-year period (15 years for research conducted outside of the United States) for tax years beginning after December 31, 2021.

What Are Qualified Research Expenditures?

QREs include wages paid to employees who perform, supervise, or support research activities, supplies used to conduct research, and "contract research expenses" incurred in conjunction with the performance of the research. In order to qualify for the credit, the research (1) must be intended to produce information or technology necessary to develop or improve a product (i.e., eliminate technical uncertainty), (2) by a process of experimentation that evaluates one or more alternatives, with (3) the activity undertaken relying on the principles of hard science, such as chemistry or engineering, and (4) with the intention of the research being useful in the development of a new or improved product or process. The research done does not have to succeed in creating a new product or process, it just has to meet the above requirements.

Based on the above requirements, the following is a list of some activities that are eligible for the R&D credit:

- Meetings to consider alternatives and progress.
- Computer-aided design work.
- Testing new materials.
- Directly supervising research.
- Developing new and improved products, processes, or formula.
- Designing prototypes, models, and tooling.
- Developing and/or applying for patents.
- Conducting testing.
- Improving manufacturing processes.
- Developing, implementing, or upgrading software systems.
- Improving or building new manufacturing facilities.
- Expending resources on outside consultants to assist in any of the above activities.

However, the following activities are specifically excluded under IRC §41 and do not qualify for the credit:

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

Who Can Claim the Deduction and How Is It Reported?

IRS Form 6765, Credit for Increasing Research Activities, is filed to claim the regular and the alternative simplified research credits. If there is a general business credit in addition to the research credit or a carryback or carryforward of the general business credit, the research credit is carried to Part III of Form 3800, General Business Credit. Partnerships and S corporations must file Form 6765 to claim the credit. All other taxpayers are generally not required to complete or file the form if their only source for the research credit is a partnership, S corporation, estate, trust, or cooperative. Instead, they can report this credit directly on Form 3800. However, this rule does not apply to a taxpayer that is an estate or trust, and the credit can be allocated to beneficiaries. Any unused portion of the credit may be carried back one year and forward 20 years. Any unused credit at the end of the 20-year carryover period may be deducted in the 21st year.

This tax-related discussion reflects an understanding of generally applicable rules and was prepared to assist in the promotion or marketing of the transactions or matters addressed. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. New York Life Insurance Company, its agents and employees may not give legal, tax or accounting advice. Individuals should consult their own professional advisors before implementing any planning strategies. The Nautilus Group® is a service of New York Life Insurance Company. SMRU 5018765 Exp. 6.30.2025