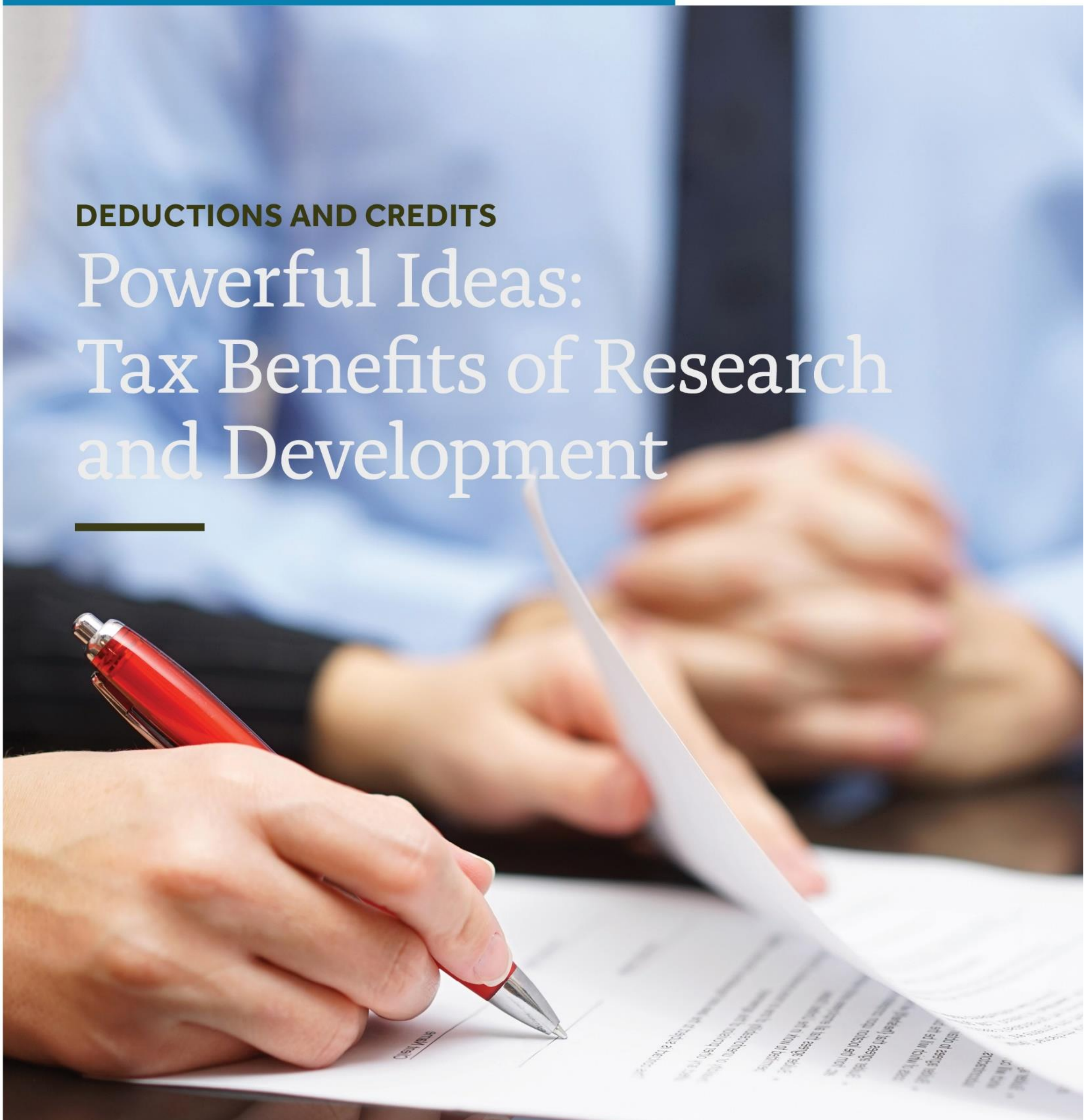
Navigating
Income Tax

DEDUCTIONS AND CREDITS

Powerful Ideas: Tax Benefits of Research and Development



Tax Benefits of Research and Development

Research and Development Credits – In General

The research and development credit (R&D credit) was created to incentivize increases in research and development by businesses. The R&D credit is found in Internal Revenue Code (IRC) §41 and is a nonrefundable credit for activities performed which are considered to be "qualified research expenditures." The credit is a dollar for dollar credit. Because it is nonrefundable, the credit cannot be in excess of income. In previous years the credit was extended annually by Congress, however, the credit was made permanent effective January 1, 2015.

What Are Qualified Research Expenditures?

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 (i.e., 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?

For companies or individuals eligible to claim the credit, the credit is calculated on Form 6575, Credit for Increasing Research Activities. If the qualified research expenditures are performed by a pass-through entity, such as a partnership or an S corporation, the benefits will be calculated at the entity level, and will be allocated to each owner and reported on their individual tax returns. If the activities are performed by a C corporation, the C corporation will calculate and receive the benefits of the credit.

Many of the costs of doing research activities are deductible in the year they are incurred. If the costs are deducted, the taxpayer cannot receive the full credit for that expense. If the taxpayer wishes to claim a credit in the same year he or she has deducted the expenses, he or she can do so by making an election to take a reduced credit under IRC §280C. As a result, the credit will be reduced by the maximum corporate tax rate (21%). The proper treatment of the credit should be discussed with local counsel because of its potential impact on state taxes.