

# Research Tax Credit Overview

(Information provided by RSM McGladrey, Inc.)

## Research Credit: Basic Computation

- Credit = 20% x Qualified Research Expenses (QRE) in excess of “base amount”
  - Equal amount of R&D expenses must be added back to taxable income to avoid double benefit
  - Election to compute credit at 13% and bypass expense add-back – must be done on original return
- Base amount = fixed base percentage x average of prior 4 years gross receipts (GR)
- Fixed base percentage is a function of QRE / GR in 1984-1988 “base period”
- Alternative formula for taxpayers lacking QRE and/or GR in at least 3 base years – “start up method”

## Alternative Simplified Credit

- Available for tax years ending after Dec. 31, 2006
- Credit based on the three prior years’ research expenses
- Not affected by gross receipts
- No historical base period
- Credit = 14% of current year QRE that exceeds 50% of average of 3 prior years’ QRE
- If no QRE in any one of the prior three years, credit is 7% of current year QRE
- Once elected, the ASC is irrevocable without consent

## Research Credit Utilization

- The research tax credit is a component of the general business credit (GBC)
- The GBC is limited to excess of “net income tax” over the greater of :
  - tentative minimum tax, or
  - 25% of “net regular tax liability” in excess of \$25,000
- Net income tax = regular tax liability + AMT liability – foreign tax credit – possessions tax credit – Puerto Rico economic activity credit
- The tentative minimum tax is treated as being zero for the GBC limitation of eligible small businesses (gross receipts of \$50,000,000 or less) for tax years beginning in 2010.
- Pass-through of credit from a partnership or S corporation is limited to the separately computed tax based on each individual’s taxable income allocable from their interest in the trade or business that engaged in the research
- Unutilized GBC may be carried back one tax year and carried forward 20 tax years
- Five-year carryback for eligible small business credits generated in tax years beginning in 2010

## Areas of Potential Qualified Activities

- Product Developments - New products versus product extensions
- Process Improvements
  - Efficiencies
  - Cost reductions
  - Pilot models and patents

## **Qualified Research – 4-Part Test**

### **1. Permitted Purpose**

The activity relates to a new or improved function, performance, reliability, or quality of a business component (i.e., product, process, computer software, technique, formula, or invention) which is to be held for sale, lease, license, or used in a trade or business.

### **2. Technological in Nature**

The activity performed must fundamentally rely on principles of:

- Physical science
- Biological science
- Computer science
- Engineering

### **3. Elimination of Uncertainty**

The activity must be intended to discover information to eliminate uncertainty concerning the capability or method for developing or improving a business component, or the appropriate design of the business component.

### **4. Process of Experimentation**

Substantially all of the activities must be elements of a process of experimentation, identifying:

- Uncertainty concerning the development or improvement of a business component
- Alternatives intended to eliminate the uncertainty
- Conducting a process of evaluating alternatives (through modeling, simulation or a systematic trial and error methodology.)

## **Qualification of Software Development**

- Internal Use Software does not qualify unless it meets the three-part high threshold of innovation test (see below).
- Software developed for the following purposes is not considered internal use software, either by definition or by exception:
  - Sale, lease or license to customers
  - Used in a production process
  - Used in conducting qualified research

- Software embedded in hardware held for sale
  - Used in providing computer services to customers
- Three-part high threshold of innovation test needed to qualify Internal Use Software:
    1. Innovative: The software is unique or novel and differs in significant and inventive ways from other software implementations and methods.
    2. Significant Economic Risk: Substantial resources are committed to development and there is substantial risk due to technical uncertainty of recovering those resources in a reasonable period.
    3. Not Commercially Available: Software which meets the business requirements cannot be purchased, leased or licensed without substantial modifications.

### **Examples of Qualified Activities**

- To advance the design of an existing product or process
- To correct significant design defects, obtain significant cost reductions, or enhanced function
- Design, construction and testing of pre-production prototypes and models
- Conceptual formulation, design and testing of possible product or process alternatives
- Launch activities involving a new component/process
- Design time, tool design and testing, prototype building, etc.
- Engineering efforts to develop new plant processes
- Technical redesign of an existing plant layout, resulting in substantial production gains
- Efforts to solve production problems where there was uncertainty as to the best solution
- Design and testing involved in improving the configuration or altering the composition of an existing product/process to increase efficiency or decrease cost

### **Examples of Non-Qualified Activities**

- Research done outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States
- Research in the social sciences, arts, or humanities
- Ordinary testing or inspection of materials or products for quality control
- Market and consumer research

- Advertising or promotion expenses
- Management studies and efficiency surveys
- Research to find and evaluate mineral deposits, including gas and oil
- Acquisition or improvement of land or of certain depreciable or depletable property used in research
- Acquisition of another person's patent, model, production, or process
- Research funded by another person, or any governmental entity, by means of a grant or contract
- Research conducted after commercial production
- Research for the adaptation of existing business components
- Research for the duplication of an existing business component

#### **Expenses Eligible for the Research Tax Credit**

- Wages
  - Box 1 W-2 Wages for those employees involved in:
    - Direct Performance of Research/Development
    - Direct Supervision of Research/Development
    - Direct Support of Research/Development
- Supplies
  - Expenses relating to tangible personal property that is not subject to depreciation
  - Must be used or consumed in the research process
- Contract Research
  - Payments must not be contingent upon the success of the research
  - Taxpayer must retain substantial rights to use the research results

#### **R&D Study Process – Phase 1**

- Pre-qualification
- Scoping
  - Business components / projects
  - Departments, employees
  - Supplies, contractors
  - Funding issues, contract review

- Base years / method
- Controlled group
- Consider statistical sample
- Determine available documentation

### **R&D Study Process – Phase 2**

- Plan/schedule field work
- Document qualified activities
  - Review documentation
  - Conduct interviews or distribute questionnaires
- Document qualified costs
  - Review timesheets or distribute time surveys
  - Review supply and contractor detail
  - Develop costing model

### **R&D Study Process – Phase 3**

- Complete project narratives, computations and reports
- Assemble deliverables
- Recommend recordkeeping process improvements
- Review with client

### **Nexus of Qualified Activities to Qualified Costs**

- Research credit rules require application of the four-part test separately for each business component
- Contemporaneous documentation proving “nexus” between qualified activities and related costs is critical
  - Project accounting / timesheets preferred
  - Courts have allowed estimates based on credible evidence but IRS field agents are less likely to allow

### **Solving the Nexus Problem**

- Recommended solution is to implement a time tracking process as soon as possible
  - Recommended vendor is Titan Armor<sup>®</sup>
  - Web based, simple to use, easy to customize
  - License is only \$295 per month plus training and implementation
- Prior periods and interim solution is for employees to complete a time survey in Excel

### **Time Survey Completion Process**

- Determine total hours worked in each year

- Example: 2080 hour work year less 3 weeks vacation and 5 holidays = 1,920 hours
- Hours for partial year employment should be reduced accordingly
- Allocate work hours in each year to all projects worked on
  - Sum of project %s plus non-project % = 100%
  - Project %s will be converted to hours by McGladrey team on QRE master schedule
- For each project, allocate 100% of time among listed activity categories
  - Subtotal qualified and non-qualified %s
- Questions / on site review by McGladrey team
- Complete sign off
- Department heads or designees complete surveys for former employees

### **Contemporaneous Documentation Examples**

- Hand sketches, design concept drawings, CAD designs showing the evolution of product designs
- Data related to the research activity, such as predicted results vs. actual results achieved
- Submissions to management, the board of directors, review committees or other similar groups regarding research projects, activities, expenditures, and the credit
- Minutes, notes, or other similar recordings from budget, board of directors, managerial or other similar meetings concerning research activities
- Literature related to the research activities, including prospectuses, annual reports, catalogs, brochures, pamphlets, press releases, etc.
- Publications discussing the research, such as treatises, papers and other published works
- Project authorizations, budgets, or work orders that initiated the research project
- Internal authorization policies for approving a research project
- Project summaries, progress reports and project meeting minutes
- Patent applications, if any