

Unclaimed R&D benefits

Is your business getting the "credits" it deserves?

By Greg Elias

Since 1981, a research and development (R&D) credit has been part of the U.S. tax law. Unfortunately, because of its complexity, many businesses -- particularly small and mid-sized ones -- have failed to take advantage of it.

The R&D credit was enacted to encourage companies to seek out and develop new products. Its purpose was to help defray the cost of research and level the playing field between U.S. business and foreign competition, particularly in technology-related industries such as chemicals, pharmaceuticals, electronics and other industrial and manufacturing areas.

Despite the fact that approximately 18,000 taxpayers claim more than \$7 billion in R&D credits each year, many smaller companies are not aware that the activities they perform to develop new products, enhance existing products or improve their manufacturing processes may qualify for R&D credits. Additionally, many are not aware that recent changes have made the R&D credit easier to claim and applicable to more activities performed by the company.

Calculating the credit

The first component of the R&D tax credit involves calculating the credit, which means knowing which expenses fall within the IRS' definition of qualified research expenses. These qualified expenses are broad in scope and often include:

- Wages of employees who work on or supervise the development of projects or manufacturing staff who are supporting the experimentation process
- Supplies used in the research or experimentation process, including raw materials, jigs, fixtures, prototypes, test beds, tooling, etc.
- Contract research expenses paid to outside consultants to help develop or test a new products or improvements

For the expenses listed above to qualify for the R&D credit, they must also comply with a four-part test, which essentially states that the activities by employees and expenses related to the R&D process must be:

- **Technological in nature.** The activity performed must fundamentally rely on the principles of physical science, biological science, engineering or computer science
- **Permitted purpose.** The activity must relate to a new or improved business component's function, performance, reliability, quality or price
- **Process of experimentation.** Many of the activities must be elements of a process of experimentation involving evaluation of alternatives, confirmation of hypotheses through evaluation, testing and/or modeling or refining or discarding of the hypotheses
- **Uncertainty must exist** concerning the best technical path to achieve the desired objective

Documenting qualifying activities

The other component of the R&D credit involves keeping proper records and documentation to prove that your company was actually trying to develop a new product or improve an existing product or manufacturing process. If audited, the IRS will look to see if:

- **There is supporting documentation.** This must relate in a meaningful way to the course of the experimental development work performed. This requirement can be filled in a variety of ways, including, but not limited to, notes, test results, CAD or paper drawings.
- **There is meaningful documentation relating to the costs incurred.** W-2 information on salaries will be examined. Also helpful, but not essential, are time cards that may identify hours, days, weeks or months spent solving problems.

The R&D tax credit is not new; however, the rules regarding what qualifies as research and development and how the credit is calculated have changed considerably over the past 20 years. Small and mid-sized firms should not underestimate or trivialize the product or process improvements they make each year.

While the calculation required in claiming the credit can be complicated, a tax professional who is familiar with the nuances of the credit can help identify hidden costs, which could yield surprising credits and possible tax refunds.

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