

Corporate Tax Update

R&D TAX CREDIT OVERVIEW

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➤ Introduction

- In general, the Research and Development (R&D) Tax Credit is available to taxpayers engaging in qualified research activities by providing tax credit equal to a percentage of certain eligible expenses called qualified research expenses (QREs)
- In addition to the federal credit, many states also have R&D tax credits

There are three main types of QREs:

- Wages
- Supplies, and
- Contractors

➤ Introduction

In order for an activity to be deemed qualified research, it must meet the following four-part test:

1. The “Section 174” test;
2. The “Discovering New Technological Information” test;
3. The “Business Component” test; and
4. The “Process of Experimentation” test

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THE FOUR PART TEST

› Part 1 | The “Section 174” test

- In order to qualify for a credit under Internal Revenue Code (IRC) Section 41, the expenses must meet the definitions in IRC Section 174, meaning the expenditure must:
 - (a) be incurred in connection with the taxpayer’s trade or business;
 - (b) not be chargeable to capital account; and
 - (c) represent a research and development cost in the experimental or laboratory sense

› Part 2 | The “Discovering New Technological Information” test

- Secondly, the activities must be undertaken for the purpose of discovering new information:
 - Research must be aimed at eliminating uncertainty concerning the development or improvement of a business component
 - The “***Patent Safe-Harbor***” rule: having a patent automatically meets the requirements of the “Discovering New Information” test

➤ Part 3 | The “Business Component” test

- Thirdly, the research activities must be intended to be useful in the development of a new or improved **business component** of the taxpayer

A business component is any:

- Product
- Process
- Computer software
- Technique
- Formula, or
- Invention

› Part 4 | The “Process of Experimentation” test

- Finally, substantially all of the activities must constitute a **process of experimentation**
- A process of experimentation is designed to evaluate one or more alternatives to achieve a result to resolve an uncertainty regarding the design, methodology, or capability

A process of experimentation must:

- (a) fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science; and
- (b) involves the identification of:
 - (i) uncertainty concerning the development or improvement of a business component,
 - (ii) the identification of one or more alternatives intended to eliminate that uncertainty, and
 - (iii) identification and conduction of a process of evaluating the alternatives

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WHAT MAY QUALIFY

➤ Potentially Qualified Activity

- New product development:
 - Products for sale
 - New production equipment
 - Prototype costs
 - New tools and dies
- Product improvements:
 - Evolutionary not necessarily revolutionary
- Process development or improvements:
 - R&D processes
 - Manufacturing processes
- Software development

➤ Qualified Activities in Manufacturing

- Improvements or customizations to existing product designs
- Significant design changes implemented in response to a product defect or inconsistency
- Development of prototypes, “first run units” and models prior to commercial viability
- New proprietary products or updates
- New manufacturing process conceptualization, design, scale-up, and testing/optimization, lean manufacturing efforts
- Tool design, customizing inserts, and other articles of manufacturing

➤ Qualified Activities in Service Industries

- Creation of new or custom designs or design plans
- Identifying flaws or conflicts in early iterations of ongoing designs
- Recommending changes to a project's development process or improving the implantation process based on technical variables
- Developing operational plans for other companies

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DOCUMENTING YOUR EFFORTS

› Documentation is Key

What type of information should be documented:

Employee Labor:

- To the extent that an employee is working on a research project, he or she should ideally be tracking their hours to that project along with a description of the tasks conducted
- If tracking is not feasible, estimates are allowed (with supporting documentation)

» Documentation is Key (continued)

What type of information should be documented:

Supplies Incurred:

- Supplies which are used/consumed in the process of research activity should be documented and tracked to the project
- **Can include:**
 - Scrapped material
 - First run units
 - Prototypes
 - Mockups
 - Other consumables used in research

➤ Documentation is Key (continued)

What type of information should be documented:

Contractors Incurred:

- Outside services should be documented and costs tracked to research projects
- This can potentially include contracted support services such as:
 - Testing
 - Data analytics
 - Surveying
- This also should include outside contracted research expenses:
 - Must be paid on a time & material or hourly basis or otherwise without economic risk to the contractor

R&D TAX CREDIT

RKL R&D STUDY PROCESS

› Identifying, Quantifying, and Supporting Qualified Expenses

Wage Analysis:

- Examines the overall R&D project “life cycle” to determine qualification
- Identifies documentation which can be used to support a credit claim
- Summarizes this information and the methodology employed in a final report deliverable

› Identifying, Quantifying, and Supporting Qualified Expenses

Supply Analysis:

- Conducts due diligence in order to understand the nature of each product being developed and how one unit can differ from another
- Identifies eligible costs and ties costs to research endeavors
- Delivers an overview of the supply cost qualification justification and methodology in the final deliverable

➤ Identifying, Quantifying, and Supporting Qualified Expenses

Contractor Analysis:

- Examines the nature of the services being contracted and whether:
 - These services would qualify as supporting one party's R&D and thus be eligible expenses for the taxpayer, or
 - Whether these services were research funded by the taxpayer and likewise claimable.

› Qualified Research Projects

The “Four-Part Test”:

- Evaluates each eligible project and whether the facts fit the elements of the “Four Part Test” and determine whether specific exclusions apply

Contractual Analysis:

- Evaluates the contractual documents in order to identify funding characterization and rights issues

› Study Process in Summary

- Throughout the study process, the RKL team works hand-in-hand with clients to fully realize their eligible benefit and document the methodology employed for a credit submittal
- The result is a highly-tailored approach to quantification of eligible expenses, qualification of underlying facts, and documentation of supporting information

FOCUSED. ON YOU.

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