

R&D Tax Credits Frequently Asked Questions



A more human resource.™

What Is the Federal R&D Tax Credit?

The research and development (“R&D”) tax credit is a federal tax credit (the “R&D Credit”) designed to encourage investment in the development and/or improvement of products, manufacturing processes and certain technologies in the United States. This federal credit allows eligible companies to receive a tax benefit and a dollar-for-dollar tax savings up to 20% (13% net) of their qualified R&D spending above a base amount calculated from prior years. Originally a temporary credit, the R&D Credit was permanently extended at the end of 2015 and was also expanded to offer a reduction in tax liability for many small to medium sized companies who previously may have been unable to take advantage of the R&D Credit.

What Are State R&D Tax Credits?

In addition to the federal R&D Credit, many states offer R&D tax credits for qualifying research activities performed within their borders. Several states also allow for the R&D tax credits to be sold or refunded, which can be a significant benefit.

Why Evaluate Your Eligibility to Claim R&D Tax Credits Now?

On December 18, 2015, the federal Protecting Americans from Tax Hikes (PATH) Act of 2015 was signed into law. This law provided the following immediate benefits to enhance the R&D Credit:

- a) Made the R&D Credit permanent;
- b) Expanded the applicability of the R&D Credit by allowing “eligible small businesses” (defined as non-publicly traded businesses with less than \$50 million in average annual gross receipts for the three preceding taxable years) to offset their Alternative Minimum Tax (AMT) liability; and
- c) Expanded the applicability of the R&D Credit by allowing “qualified small businesses” (defined as businesses with less than \$5 million in gross receipts for the tax year that did not have gross receipts for any tax year before the 5 tax years ending with the taxable year) to offset their payroll tax liability up to \$250,000 annually.¹

¹ See IRC section 41 (2016); Protecting Americans from Tax Hikes Act of 2015, Consolidated Appropriations Act 2016, Division Q, H.R. 2029, 114th Congress (2015-2016).

R&D Tax Credit FAQ

What Are Qualified R&D Activities?

The definition of what R&D activities and costs qualify for the R&D Credit is much broader and more comprehensive than many companies realize. Broadly stated, a company may be conducting qualifying R&D activities for purposes of the R&D Credit if they have invested time and resources into attempting to create or improve a product, process, method, technique, formula, invention, or software application within the United States.

While not an exhaustive list, here are a few examples of R&D activities that generally qualify:

- a) Developing or designing new products, processes, formulations, or systems
- b) Developing prototypes or pilot models
- c) Modifying or redesigning existing processes or systems
- d) Researching product and material alternatives/substitutions
- e) Developing new or improved manufacturing processes
- f) Developing or applying for patents for products or processes that were being developed in the United States
- g) Directly supporting or supervising research activities
- h) Developing internal software solutions and/or applications

Qualified R&D research activities are those activities that meet the following general “four-part” test:

Permitted purpose (I.R.C. §41)

The activity must relate to a new/improved business component:

- Function
- Performance
- Reliability, and / or
- Quality

Technology in nature (I.R.C. §41)

The activity performed must fundamentally rely on principles of:

- Physical or Biological Science
- Engineering
- Computer Science

Elimination of uncertainty (I.R.C. §174)

The activity must be intended to discover information to eliminate uncertainty concerning the:

- Capability,
- Method, and / or
- Design

for developing or improving a business component

Process of experimentation (I.R.C. §41)

- The taxpayer must engage in an evaluative process that is capable of identifying and **evaluating one of more alternatives** to achieve a result
- This may include modeling, simulation or a systematic trial and error methodology

*A business component includes any product, process, computer software, technique, formula, or invention which is to be (A) held for sale, lease, or license, or (B) used by the taxpayer in a trade or business of the taxpayer.

R&D Tax Credit FAQ

The following additional “three-part” test also applies for internal use software:

Innovation Test

The software is intended to result in:

- Reduction in cost
- Improvement in speed, and/or
- Other measurable improvement

that is substantial and economically significant if the development is or would have been successful

Technology in nature (I.R.C. §41)

The activity performed must fundamentally rely on principles of:

- Physical or Biological Science
- Engineering
- Computer Science

Significant Economic Risk Test

The software development involves:

- substantial resources committed to the development, and
- substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period

“Substantial uncertainty” requires a higher level of uncertainty and technical risk than that required under the 4-part test, however, does not require technical uncertainty regarding whether the final result can ever be achieved.

What Are Qualified R&D Expenses?

The R&D expenses eligible for the R&D Credit are called QREs (Qualified Research Expenses) and are defined as the sum of in-house research expenses and contract research expenses. **These expenses generally include:**

- Wages** - This number includes the wages of personnel directly involved in, supervising or supporting qualified R&D activities. If an individual spends 80% or more of their time working in the R&D qualified services, then 100% of their wages are counted when calculating the R&D Credit. If the percentage of time spent is less than 80%, then the actual percentage of time the individual spends in the R&D qualified services is multiplied by his or her salary and allocated.
- Supplies** - Most tangible personal property used or consumed during the qualified R&D activity (excluding land, land improvements, and other depreciable property).
- Contract Research** – Usually 65% of the amount paid to a contractor or vendor brought in to conduct or support the qualified R&D activity or 75% of contract research performed by a qualified research group such as a University or consortium.

R&D Tax Credit FAQ

What Is Involved In Completing An R&D Tax Credit Study and How Can ADP Assist?

R&D tax credits present an opportunity to help grow your cash flow, but applying for the R&D tax credits and recording your expenses can be difficult. Securing federal and state R&D tax credits requires knowledge of IRS record and other requirements along with technical experience, and knowledge of the products and processes for credit entitlement. Additionally, the laws around tax credits and incentives keep changing. And, many businesses lack the resources to know which of their activities could allow them to benefit from the credits.

Lastly, defining the real cost of R&D is often made even more problematic because only a small number of companies have project accounting systems that capture the cost of support provided by the numerous employees who collaborate on R&D activities. Often times, project tracking systems don't take account of contractor fees, direct support costs, or the wages of high-level staff who contribute in any given research effort. Many project accounting systems also aren't configured to track time or expenditures to the exact activities or subcomponents of a project.

Because of these things, businesses that want to claim the R&D tax credits often work with an R&D credit service provider like ADP to complete the R&D Credit study. The following process is typically employed by ADP in completing an R&D Credit study:

- a) Initial (and complimentary) assessment to preliminarily determine your business's eligibility and the potential credit amount for which your company may be eligible;
- b) Engage ADP to perform a high-quality R&D credits study utilizing KPMG's tax and engineering professionals;
- c) Typically within two weeks of receiving all necessary financial and other applicable data, the R&D credits for which your company is eligible will be computed by ADP and KPMG;
- d) Completion of the tax forms necessary for claiming the federal R&D Credit and any applicable state credits; and
- e) Within 4 – 12 weeks, the R&D Credits deliverable, including supporting documentation to support the credit claim, will be provided.

After an R&D Credit study is completed and to the extent required and applicable, ADP, in collaboration with KPMG, is available to provide audit support.

How Much Does It Cost to Complete the R&D Tax Credit Study & When Do We Receive the Benefit?

ADP offers fixed-fee pricing based on an estimation of time and expense required to complete a comprehensive study. The preliminary fee range can typically be provided after an initial, complimentary phone conversation with ADP and KPMG professionals. We offer fixed-fee pricing so that you can budget for the cost at the outset of the project.

In terms of when you can expect to receive an R&D Credit benefit, it all depends on the opportunities that apply to your business. We will work with you to understand your business's particular circumstances and provide an approximation of when you can expect to receive the benefit associated with any R&D Credits claimed.

R&D Tax Credit FAQ

How Are the R&D Tax Credits Monetized?

R&D Credits can be monetized in a variety of ways. For example, a corporate taxpayer would include two additional forms with their federal income tax return and the R&D Credit will directly reduce the tax liability for that corporate taxpayer on that federal income tax return. For those that are eligible to offset payroll tax liability, the payroll tax offset would be claimed on the quarterly payroll tax filing that immediately follows a company's federal income tax filing. Additionally, state credits may be sellable or refundable. ADP will not only work with you to help you better understand the process, we'll help you with the completion of any forms necessary for your company to claim the R&D Credits for which you are eligible.

It's important to note that federal taxpayers can also claim the R&D Credit retroactively by filing amended returns for the past three tax years (or more if your company endured losses during that time). This makes it a good way to recoup tax previously paid. In addition, state taxpayers may also be able to amend returns that go back even further.

Why Choose ADP's R&D Tax Credit Service Offering?

ADP has decided to bring to market an offering that will help eligible businesses conduct an R&D Credit study in an efficient and effective manner. To accomplish this, ADP is collaborating with KPMG, a Big 4 accounting firm, to deliver the R&D Credit services. You will have access to KPMG's experienced, national team of over 400 tax and engineering professionals who will assist in the analysis and documentation of qualified research activities and the associated expenses required to compute your business's eligible R&D Credit. Additionally, if ADP is your payroll provider, ADP will already have much of the wage data required for the R&D study, which may allow the study to be conducted in a more efficient manner.

The information contained herein constitutes proprietary and confidential information of ADP. It must not be copied, transmitted, or distributed in any form or by any means, electronic, mechanical, or other, including photocopy, recording, or any information storage and retrieval system, without the express written permission of ADP. The information provided herein is for informational purposes only and not for the purpose of providing legal, accounting, or tax advice. The information and services ADP provides should not be deemed a substitute for the advice of any such professional. Such information is by nature subject to revision and may not be the most current information available.