

Federal Research (R&D) Tax Credit

There are generally two methods currently available in calculating the Federal tax credit for increasing research expenditures under Internal Revenue Code Section 41 or as it is more commonly known as the R&D Tax Credit. The credit was extended on January 2, 2013 for years 2012 and 2013, and unless extended by Congress again, the credit does not apply for costs paid or incurred after December 31, 2013.

Under the **“Regular”** credit calculation, the credit is equal to 20% of the excess of qualified research expenditures or QRE over a base amount with a corresponding expense reduction for the amount of the credit. In the alternative, a reduced credit equal to 13% can be used with no expense reduction. Excess QRE are capped at 50% of the current year expenditures.

As an alternative to the “Regular” tax credit calculation, there is also an **“Alternative Simplified Credit”** method for qualified research expenses. A taxpayer can elect to take a credit equal to 14% of the excess of the qualified research expenses over 50% of the average QRE for the three tax years preceding the tax year with a corresponding expense reduction for the amount of the credit. In the alternative, a reduced credit equal to 9.1% can be used with no expense reduction. If the taxpayer has no qualified research expenses in any one of the three preceding tax years, the alternative simplified research credit is 6% (or 3.9% reduced credit) of the qualified research expenses for the tax year for which the credit is being determined. An election to use the alternative simplified research credit applies to the tax year and all succeeding tax years unless revoked with IRS consent.

In calculating the research credit, taxpayers can take into account in-house research expenses and contract research expenses. **In-house research includes wages, supplies, and the cost for computer use.** Outside contract research expenses are also eligible for the credit but are limited to 65% of the cost. Indirect costs and overhead expenses cannot be used to calculate the credit.

The following costs are used to calculate the credit:

- Wages (from Form W-2) of personnel directly involved in qualified research;
- Wages (from Form W-2) for supervisory personnel who supervise personnel directly involved in qualified research;
- Wages (from Form W-2) for administrative personnel who provide “direct support” of either actual researchers or persons directly supervising them.....**Examples:**
 - Secretary typing reports describing laboratory results,
 - Laboratory worker cleaning equipment used in qualified research,
 - Clerk compiling research data,
 - Machinist machining a part or component for an experimental model.
- Supplies and materials used or consumed in the conduct of qualified research;
- Payments for the right to use computers; and
- 65% of contract research in which the taxpayer retains ownership of the results including all related benefits and the risk of loss if unsuccessful.

Note that wages for qualified research (above) is generally apportioned based on a ratio of total hours spent on qualified research over total hours spent actually working as an employee. For computational purposes, hours paid for vacation time, holidays, and sick leave is usually excluded from the employee’s total hours.

Research Credit Questionnaire

THE (4) FOUR-PART TEST: QUALIFIED RESEARCH EXPENDITURES (QRE)

1. A new or improved **BUSINESS COMPONENT** (see matrix below)
2. **TECHNOLOGICAL** in nature
3. **UNCERTAINTY** as to capability, method or final design
4. **PROCESS OF EXPERIMENTATION** to remove the uncertainty

Business Component Purpose Matrix					
The Project's Business Components	The Purposes of the R&D Activities Related To The Development of <u>New or Improved Product or Process, etc. :</u>				
	Function	Performance	Reliability	Quality	Durability
Product	✓	✓	✓	✓	✓
Process	✓	✓	✓	✓	✓
Computer Software	✓	✓	✓	✓	✓
Technique	✓	✓	✓	✓	✓
Formula	✓	✓	✓	✓	✓
Invention	✓	✓	✓	✓	✓

(1) Description of Project

- (a) General description _____
- (b) Targeted users of product (this question is important in identifying internal use software projects) _____
- (c) When was development started? _____
- (d) When was development completed? _____
- (e) General description of development activities the period.

- (f) Description of patents resulting from project, or patented applied for.

(2) Code Sec. 174 Test

The research credit requires that costs for which a credit is claimed are associated with an activity that is Research and Experimentation, as that term is defined in Code Sec. 174. Code Sec. 174 defines R&E as costs incurred in connection with the taxpayer's trade or business that are research and development costs in the experimental or laboratory sense. The costs must be incurred in connection with activities intended to eliminate uncertainty concerning the development or improvement of a product. Whether costs are R & E expenditures, under Code Sec. 174, depends on the nature of the activity to which the expenditures relate, not the product to which they relate, or the level of technology involved. A product, for this purpose, "includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license." Reg § 1.174-2(a)(1) . The regulations provide that Code Sec. 174 will apply "not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor)." Reg § 1.174-2(a)(8) ; See Safstrom, Thomas A., (1992) TC Memo 1992-587 , RIA TC Memo ¶192587 , 64 CCH TCM 971 , affd without op (1994, CA9) 74 AFTR 2d 94-7284 , 42 F3d 1401 , 95-1 USTC.

NOTE: The Code Sec. 174 test cannot be met if the taxpayer is not at risk in the development. For instance, if the taxpayer engages an independent contractor to perform all or part of the work, and if the contract is the equivalent of a purchase of a finished component (e.g., a completed piece of software) the Code Sec. 174 is not met. Describe how the R&E project associated with the costs in question meet the requirements of these rules.

(3) Technical Information Test

Research activities qualifying for the credit include only those undertaken for the purpose of gaining knowledge that is technical in nature. Information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. A taxpayer may employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science to satisfy this requirement. Reg § 1.41-4(a)(3) , Reg § 1.41-4(a)(4) . Research does not qualify if it relates to style, taste, and cosmetic or seasonal design factors. Reg § 1.41-4(a)(5)(ii) .

The issuance of a patent is conclusive evidence that this test is met. However, issuance of a patent is not a pre-condition for meeting this test. Reg § 1.41-4(a)(3)(iii) .

(a) Describe the technical nature of the new information sought.

(b) Was a patent issued with respect to the product of the research?

(4) Business Component Test

The information sought must be intended to be useful in the development of a new or improved business component of the taxpayer. Code Sec. 41(d)(1)(B)(ii) .

Describe the new or improved business component, product, or process that is to result from the research.

(5) Process of Experimentation

Qualified research must include a process of experimentation. This is a process of evaluating more than one alternative to achieve a result. At the outset of the process the capability or method of achieving the desired result must be uncertain. Taxpayers are required to document that more than one method of achieving the desired goal, or gaining the desired information, was explored, and that the capability or method of achieving the end result was uncertain at the outset.

(a) Describe how the method of the desired goal (the goal identified in (a), above) is uncertain.

(b) Discuss, in general, the various alternatives to be explored in the research project.

(c) Describe the results of each alternative approach explored.

(6) Documentation Checklist

(a) A separate file for each project was created at the outset of the research project (or no later than the time for filing the tax return claiming the credit) containing all of the documentation to support qualification for the credit.

(b) Skilled professionals have been engaged to carry out the project. Copies of resumes are in the research documentation file.

(c) The file contains a clear description of the problem to be researched.

(d) A memo explaining how more than one method of achieving the desired goal, or gaining the desired information, needs to be explored, and how the capability or method of achieving the end result is uncertain at the outset.

(e) While each step of a process of experimentation need not be documented, taxpayers should have periodic progress reports that discuss the ongoing results of each line of research.
