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How Can the R&D Credit Help You?

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The PATH Act of 2015 expanded and made permanent the credit for increasing research activities, commonly referred to as the R&D credit. The expansion of this credit made it much more attainable for many firms across all industries, while the permanency provides the opportunity for long-term planning in the research and development area. This is an under-utilized tax incentive as many firms believe themselves to be too small or in the wrong industry to qualify.

What Changed?

In the past, businesses could only use the R&D credit against their regular tax liability. Now, eligible small businesses can apply the credit against their Alternative Minimum Tax (AMT). An eligible small business is a closely held company with average gross receipts of $50 million or less for the prior 3 tax years. Additionally, during their first 5 years of existence, startup companies with $5 million or less in revenue can apply the credit against their employer payroll tax up to $250,000. The credit is also available for pass-through entities, meaning the credit can pass to the individual owners to offset their individual tax liability.

What Qualifies?

The credit applies to any qualified research expenses for the taxable year and is not limited to any specific industry. The eligible expenses consist of wages paid to employees, supplies purchased, and payments for contracted services as long as they are performed or incurred in a qualified research activity. "Qualified research" means that which is technological in nature and is intended to develop new or improved functionality, performance, reliability, or quality of a product, process, computer software, technique or formula. Furthermore, "qualified research" means that substantially all of the activity involves a process of experimentation or evaluation of alternatives. "Qualified research" does not include duplication or reverse engineering of existing products, adaptation of an existing function to a particular customer's needs, or conducting surveys or studies. However, qualification for the credit is not limited to successful ventures, as long as the attempt for the new or improved process or functionality was made.

How much is the Credit?

In general, the credit is equal to 20% of the excess of qualified research expenses over a base amount (derived from prior years' qualified research expenses and the taxpayer's gross receipts). As the computation of the base amount can become time consuming and costly, taxpayers may instead elect the Alternative Simplified Credit (ASC). The ASC is equal to 14% of the excess of qualified research expenses (QREs) over 50% of the average QREs for the 3 preceding tax years. According to our BDO Alliance team members, the credit generally averages 5% to 10% of qualified costs.

Other Considerations

In addition to this federal credit, many states also offer some form of the R&D credit and some states offer refundable or transferable credits. Furthermore, the federal and many state R&D credits are available for certain carryover periods, which is particularly beneficial for businesses that have incurred losses and have no taxable income. Finally, proper documentation is a key aspect for claiming the credit and successfully defending this position before the IRS. According to a recent article from BDO USA, LLP, as long as your business is at economic risk for the qualifying activities, then the expenditures are likely to qualify for the credit.

Possible industries that overlook the R&D credit include engineers, software developers, architects, and construction. See below for qualifying activities.

Examples of engineering and designing activities that may be eligible for the R&D Tax Credit include:[1]

- **Architects:** Developing new or improved designs; overcoming design obstacles through evaluating and considering different design alternatives; assessing design through various forms of modeling and computational analysis.
- **Civil Engineering:** Analyzing land, grade, and soil conditions; traffic management analysis; utility design; pavement and sidewalk design; and wastewater management system design.
- **Structural Engineering:** Designing structures and structural components to withstand stresses and pressures. Factors include analysis of and experimenting with structural

[1] KBKG. (2016, May 17). *Research Tax Credit Opportunities for Architects and Engineers.* Retrieved from the KBKG website: http://kbkg.com/tax-insight/rd-opportunities-architects-engineers

components, building materials, occupancy load, building use, environmental pressures, safety, soil, and site considerations.

- **Electrical Engineering:** Designing systems for optimal power, lighting, communications, alarm, lightning protection, grounding, and instrumentation and control; simulating daylighting conditions.
- **Mechanical Engineering:** Designing systems for improving heating, cooling, humidifying/dehumidifying, cleaning, ventilating, and component integration for optimal effectiveness; conducting energy modeling for assessing energy efficient designs.
- **Fire Protection Engineering:** Analyzing materials, structures, industrial processes, and transportation systems for fire hazards and properly designing fire protection system to mitigate fire damage.

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