



Claiming the Federal R&D Tax Credit

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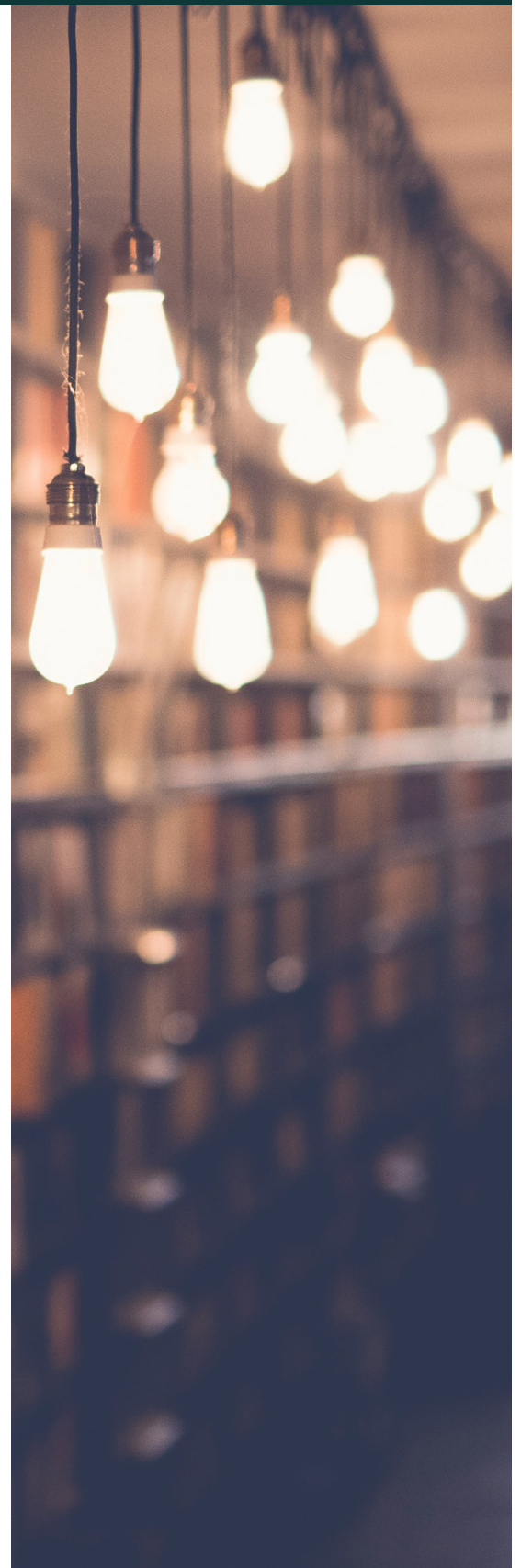
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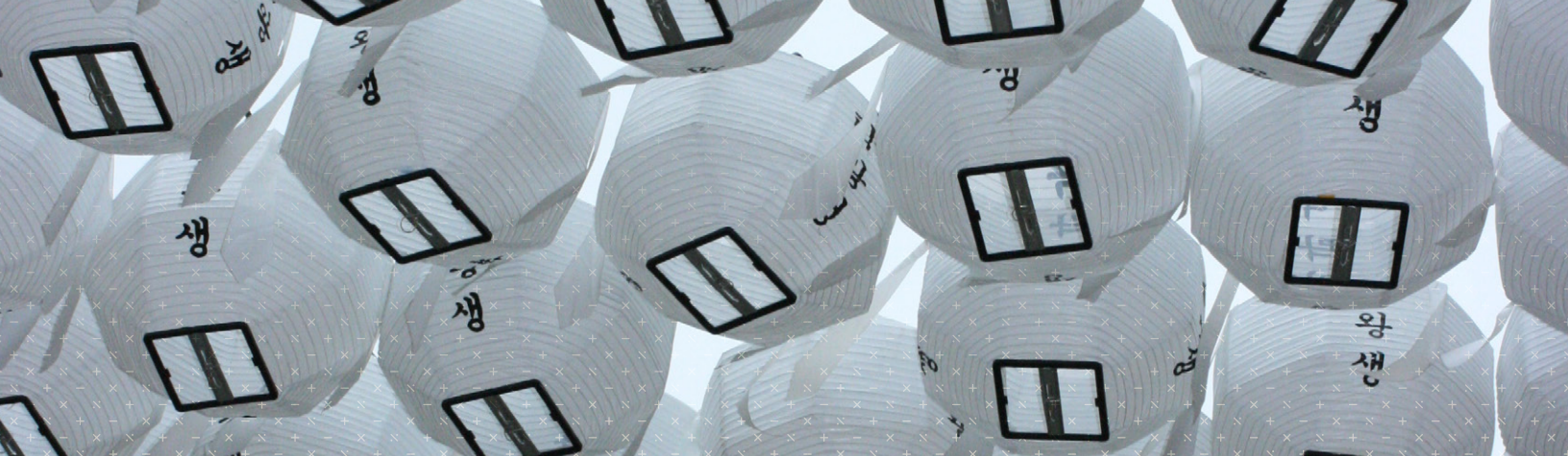
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INTRODUCTION

Over 100,000 US taxpayers collectively claimed more than \$12 billion in federal R&D tax credits for work their companies performed on a day-to-day basis over the course of a year, according to the most recent reporting. While there's no question that large, Fortune 500 companies account for a significant portion of the overall research performed and the credit dollars claimed each year, it's important to note that the R&D tax credit isn't limited to large companies with established R&D departments. In fact, Congress has taken action over the past five years to expand the amount of credits available to small and medium-sized companies and business owners.

There's no limit on the number of dollars available to US taxpayers that qualify for the R&D tax credit, and millions undoubtedly go unclaimed each year. Regardless of industry, any company that develops new or improved products, processes, or software could qualify under the US tax code.





DO YOU QUALIFY?

Regardless of industry, size, or revenue, any company that performs activities that meet the following four tests may qualify for R&D tax credits:

Qualifiers

TECHNICAL UNCERTAINTY

The activity is performed to eliminate technical uncertainty about the development or improvement of a product or process, which includes computer software, techniques, formulas, and inventions.

PROCESS OF EXPERIMENTATION

The activities include some process of experimentation undertaken to eliminate or resolve a technical uncertainty. This process involves an evaluation of alternative solutions or approaches and is performed through modeling, simulation, systematic trial and error, or other methods.

TECHNOLOGICAL IN NATURE

The process of experimentation relies on the hard sciences, such as engineering, physics, chemistry, biology, or computer science.

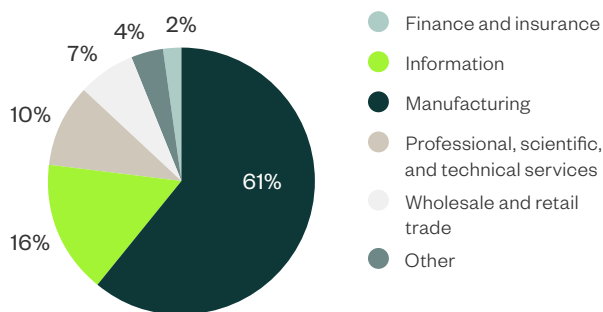
QUALIFIED PURPOSE

The purpose of the activity is to create a new or improved product or process—computer software included—that results in increased performance, function, reliability, or quality.

Companies can qualify for the R&D tax credit based on activities they already perform. Companies with potential R&D activities frequently:

- Develop processes, patents, formulas, techniques, prototypes, or software
- Improve or redesign existing products
- Hire scientists, designers, or engineers
- Devote time and resources to creating (manufacturing or developing) new or innovative products
- Develop patents or other types of intellectual property

R&D Tax Credits Claimed by Industry



Source: IRS Statistics of Income, "Corporations Claiming a Credit by Industrial Sector." www.irs.gov/uac/SOI-Tax-Stats-Corporation-Research-Credit-Data as of 2012, the most recent data available from the IRS.

Typical R&D companies—professional, scientific, and technical services companies—make up only 10% of all credits claimed. The number of R&D tax credit claims by construction companies is also growing every year. A number of industries roll up into manufacturing. In order of significance, these include:

- Computer and electronic product manufacturing
- Chemical manufacturing
- Machinery manufacturing
- Electrical equipment, appliance, and component manufacturing
- All other manufacturing

BENEFITS

Qualifying Expenses

Amounts paid for salaries, supplies, contract research, and computer leasing could all qualify for the R&D tax credit.

Salaries paid to employees who conduct qualified activities are generally one of the largest components in an R&D tax credit claim, though this may not be true for pharmaceutical and construction companies, for example, whose most prominent expenses are often contract research. Money paid to the engineers performing qualified R&D activities—as well as first-line managers and personnel who directly support these engineers—can qualify.

A portion of payments made to United States-based contractors as well as any supplies consumed in the R&D process are also eligible. Additionally, a portion of payments made to cloud service providers may qualify if they relate to qualified R&D activities, such as testing or development in the cloud as opposed to simple file storage or hosting for stable software releases. However, qualified supplies are rarely seen in companies claiming credits purely for software development activities.



QUALIFIED COSTS



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Up to 10% of total qualified costs can be claimed as a federal R&D tax credit.

QUALIFIED ACTIVITY CRITERIA

There's technical uncertainty	✓
There's a process of experimentation	✓
It's technological in nature	✓
It's conducted for a qualified purpose	✓
It isn't:	✓
<ul style="list-style-type: none">• Research performed after commercial production*• Duplication or reverse engineering*• Application of custom-built component for a particular customer's requirements or needs*• Survey studies, market research, or routine data collection• Foreign research performed outside the US (including US possessions)	
All conditions met = Activity qualifies	✓✓✓✓✓

* These activities can still qualify for the R&D tax credit if they otherwise meet the tenants of the four-part test.

Dollar-for-Dollar Tax Credit

Up to 11% of a company's annual eligible costs can be applied, dollar for dollar, against its federal income tax liability. Moreover, 36 US states have their own R&D tax credit programs. These come in varying incentive amounts, and many closely resemble or even mirror the federal rules regarding what types of activities and expenses are eligible. The method used for computing the credits can vary from jurisdiction to jurisdiction, but in most cases, a taxpayer's current year R&D spending is compared to R&D spending incurred in previous years—known as base years—and the taxpayer will receive a percentage of the amount exceeding the base. While the mechanics of the computation vary, most taxpayers will receive a larger credit if they can show an increase in R&D spending year after year. Other alternatives are also available for companies that aren't able to establish a baseline of research spending in prior years.

QUALIFIED EXPENSE CRITERIA (BY TYPE)

Wages	✓
They're W-2 taxable income	✓
They're paid to an employee who performs, directly supports, or supervises qualifying activities	✓
They meet the "substantially all" test	✓
Supplies	✓
They're either tangible personal property, extraordinary utilities, or computers	✓
They aren't capital items or general administrative supplies	✓
Contract Research	✓
It would qualify if performed by a direct employee	✓
It's performed under an agreement that puts the credit claimant at a financial risk while granting it substantial (including shared) rights over the final product	✓
Generally, it isn't more than 65% of what's paid to contractors	✓
Computer Leasing	✓
It's paid to a cloud service provider for hosting software under development (not for hosting a stable software release)	✓

Credit Carryforward

If you don't currently have a tax liability but your activities qualify, it's still important you document R&D expenses along the way. R&D costs incurred in years when a company has no income can be carried forward to offset tax on future profit. In most cases, any credits that can't be used immediately—due to losses, for example—will carry forward for up to 20 years.

Retroactive Claims

Federal taxpayers can also claim the R&D tax 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. For example, the California statute is open for four years.



FAVORABLE CHANGES

Many companies aren't including all the expenses they're entitled to claim on their tax returns despite the fact that the landscape of R&D rules, IRS policy, and legal interpretations has led to a net increase in R&D-eligible activities in the past couple years.

Permanence

On December 18, 2015, the federal R&D tax credit was made permanent by the Protecting Americans from Tax Hikes Act (the PATH Act), breaking from the previous pattern of annual year-end—and often retroactive—extensions. Businesses have long complained that the annual threat of extinction to the credit deterred them from pursuing critical research into new products and technologies. Thanks to the credit's now-permanent status, companies can factor a federal income tax reduction into their financial planning with more certainty.

Alternative Minimum Tax

In addition to the permanent extension, beginning in 2016, eligible small businesses whose credits were previously limited by the alternative minimum tax (AMT) gained the ability to use their credits. Eligible small businesses are sole proprietorships, partnerships, and nonpublicly traded corporations with \$50 million or less in average annual gross receipts for the prior three years. Generally, the amount of R&D tax credit taxpayers can claim in any given year is limited by the amount of tentative minimum tax they owe. However, the PATH Act permits eligible small businesses to use credits to fully offset their tax liability without regard to tentative minimum tax. Taxpayers with an income tax liability of more than \$25,000 will still be subject to the 25/25 limitation—25% of the amount that

exceeds \$25,000—so they may not be able to take their tax liability all the way down to zero.

Payroll Tax

Start-up companies may be eligible to apply the R&D tax credit against their payroll tax for up to five years starting in 2016—an enhancement that came along with the credit's permanent extension under the PATH Act. The credit is still based on credit-eligible R&D expenses, but offsets apply to only those costs incurred after the start of 2016.

The new payroll tax offset allows companies to receive a benefit for their research activities regardless of whether they're profitable. The new payroll tax offset is available only to companies that have the following:

- Gross receipts for five years or less
- Less than \$5 million in gross receipts in 2016 and for each subsequent year the credit is elected
- Qualifying research activities and expenditures
- Payroll expenditures

The maximum benefit an eligible company is allowed to claim against payroll tax each year under the new law is \$250,000. The offset applies against the employer's portion of social security tax—6.2% up to the wage base—for all employees, not just employees who are participating in qualified research. The credit must be elected on an originally filed return; taxpayers won't be able to amend their returns to take advantage of this incentive.

Brand new businesses could potentially claim the credit for up to five years with a maximum of \$1.25 million in total credits claimed on their quarterly payroll tax returns filed with the federal government.

The benefit will be between 6% and 14% of a company's eligible R&D costs. For the majority of new or small businesses that incur at least \$300,000 in eligible R&D costs, the federal credit to offset payroll tax will be equal to 10% of their total R&D expenses.

For example, a company with \$500,000 of eligible expenses—let's say engineering costs—could have a credit of \$50,000, while a company with over \$2.5 million in eligible expenses in 2016 could have a credit subject to the full \$250,000 annual limitation. If the amount of the credit exceeds a company's social security tax (OASDI tax) liability in any given quarter, the excess will be carried forward to the next calendar quarter.

IRS LB&I Directive on ASC 730 for R&D Tax Credits

As a result of a recent IRS directive, taxpayers may be able to reduce the risk associated with claiming an R&D tax credit—and potentially generate an increased credit amount. On September 22, 2017, the IRS publicly released guidance for large business and international (LB&I) examiners regarding the examination of certain R&D expenses under Financial Accounting Standards Board Accounting Standards Codification Topic 730, *Research and Development*. The directive—LB&I-04-0917-005—indicates the IRS won't challenge certain qualified research expenses (QREs) that are a taxpayer's adjusted ASC 730 financial statement R&D costs.

With this guidance, taxpayers now have the option to reconcile ASC 730 with the QRE claimed on their tax return by adjusting ASC 730 financial statement R&D costs to arrive at the amount the IRS considers as qualifying for safe harbor. Safe harbor, in this instance, means the IRS won't challenge the amount.

Eligibility Requirements

The opportunity is for LB&I taxpayers that have more than \$10 million in assets and follow US generally accepted accounting principles (GAAP) to prepare certified audited financial statements. This includes C corporations, S corporations, partnerships, and LLCs that claim R&D tax credits.

Specifically, taxpayers who will likely benefit the most are those who perform domestic-based R&D that's self-funded and self-performed. Self-funded here means there's no outside government funding or customer contracts, and self-performed means the majority of R&D expenses are allocated to internal employee costs rather than services by third-party contractors.

Mechanics—ASC 730 Directive Versus the Historic R&D Tax Credit

Here's a breakdown of expenses allowed and excluded with historic R&D tax credits as well as under the directive.

QUALIFIED EMPLOYEE WAGES

The historic R&D tax credit QRE calculation identifies a qualification percentage for each R&D employee. The directive, on the other hand, allows for inclusion of the following percentages of wages paid to the corresponding employee types:

- 95% of wages and stock options for each qualifying employee whose wages are charged to US ASC 730 cost centers or those cost centers that are included in the company's financial statement R&D. This includes qualified individual contributors—those who don't manage other employees—as well as first-level managers—those who directly manages qualified individual contributors only. These designations are role based not title based, and taxpayers who choose the directive method should consider the availability of the necessary support for each employee's designation.
- Either 10% of the above calculated qualified individual contributors and first-level manager amounts, or, 100% of wages and stock options for upper-level managers, defined as those who directly supervise any employee other than qualified individual contributors and whose wages are charged to ASC 730 cost centers. Whichever amount is lower can be included.

QUALIFIED SUPPLIES & QUALIFIED COMPUTER RENTAL COSTS

The directive also allows for inclusion of amounts expensed in ASC 730 R&D accounts related to development supplies used and consumed in the US, affording safe harbor treatment to these supply amounts.

Similarly, the directive allows for inclusion of amounts expensed in ASC 730 R&D accounts relating to development-based computer rental costs as covered by the safe harbor.

QUALIFIED CONTRACTOR COSTS

While historic R&D tax credits allow for a taxpayer's inclusion of certain expenses for third-party contractors performing R&D services on their behalf, the directive specifically excludes these amounts as a qualified expense.

DIRECTIVE ELECTION PROCEDURE

You'll file the same Form 6765 with the tax return to claim federal R&D tax credits, using the QREs from the taxable year. However, your company now calculates and reports QREs based on two components.

The first is ASC 730 Financial Statement R&D QRE, which includes items that will be protected from IRS challenge if calculated according to the new guidance. The second component is non-ASC 730-based QRE. This is composed of the remaining QRE items that either don't meet the ASC 730 directive criteria or come from non-ASC 730 accounts but you wish to still include in the R&D tax credit calculation.

Keep in mind that the safe harbor doesn't apply to these second component QRE items, so they're still subject to full IRS examination.

State Conformance

Currently, not all states have determined whether they'll adopt the ASC 730 method for calculating credits at the state level. However, in February 2018, the California Franchise Tax Board announced that it will fully adopt the ASC 730 directive method, provided that additional adjustments are made to include only those costs incurred that relate to activities or services performed in California.

TAX REFORM

Tax reform, known as the Tax Cuts and Jobs Act (TCJA), retains the R&D tax credit in its current form. However, several features of the TCJA could have a profound impact on companies that claim research credits and the ability to deduct research expenditures.

Following are some of the biggest changes.

Increase in Credit from Decrease in Tax Rates

Previous Law

Taxpayers couldn't take a deduction under Section 174 of the Internal Revenue Code (IRC) equal to the amount of the R&D tax credit. This prevented companies from getting a double tax benefit, and taxpayers were required to reduce their R&D expenses by the amount of the credit. The reduction in expenses created an increase to income and any corresponding taxes.

Taxpayers could avoid the reduction of their research expenses by electing to take a reduced credit in accordance with IRC Section 280C(c)(3). This election reduced the research credit by the amount of tax savings created by the double tax benefit. The Section 280C(c) benefit was calculated using the maximum corporate tax rate.

Moving Forward

Section 280C(c) was retained in the TCJA. However, because the maximum corporate tax rate is going down from 35% to 21%, taxpayers will see an increased credit.

Increased Credit Usability from Elimination of Corporate AMT

Previous Law

The corporate AMT was set to 20%. This meant that regardless of any credits or deductions, corporations would still be taxed at a minimum rate of 20%.

Moving Forward

With corporate rates going down to 21%, the AMT rate was eliminated.

Nevertheless, there's still one limitation remaining on R&D tax credits to prevent taxpayers from using the credit to completely eliminate their tax liability. The rule, effectively known as the 25/25 limitation, restricts taxpayers with over \$25,000 in regular tax liability from offsetting more than 75% of their regular tax liability using the credit.

Increased Credit Usability from Higher AMT Exemptions for Individual Taxpayers

Previous Law

Individual taxpayers were sometimes prevented from using the credit because of AMT at the individual level.

Moving Forward

The AMT exemptions for individual taxpayers are increasing. As a result, individual taxpayers are likely to use more of the R&D tax credits passing through to them from their businesses.

Amortization of R&D Expenses Starting in Tax Year 2022

Previous Law

Taxpayers could choose to deduct their R&D expenses or charge them to a capital account if they make an election under Section 174.

Moving Forward

After 2021, companies will no longer be able to immediately expense costs that are treated as specified Section 174 research expenses. Instead, they'll be required to charge US-based research expenses to a capital account and deduct them over a five-year period. Expenses incurred for research performed outside of the United States will be charged to a capital account and deducted over a 15-year period.

Intense lobbying to eliminate or prolong this provision is expected in the coming years.

Alternative Simplified Method

Rules published February 27, 2014, allow companies to go back and claim R&D tax credits on amended returns under the alternative simplified credit (ASC) method for all open tax years. This is good news for organizations that previously missed out on claiming the R&D tax credit because of a lack of substantiation in the base years.

In the past, IRS regulations specified that a taxpayer making an ASC election had to do so by attaching Form 6765, Credit for Increasing Research Activities, to an original return for the year to which it applied. Many tax practitioners argued that the burden of substantiating expenditures and costs for the base period, which require a taxpayer to substantiate activities as far back as 1984 under the regular credit, can be difficult and time consuming. As a result, some taxpayers passed on claiming an R&D tax credit altogether.

The newer rules ease this burden. However, they stipulate that a taxpayer may not make an ASC election for a tax year on an amended return if it already claimed a credit for that tax year using the traditional method. Permitting such a change could have resulted in more than one audit of a taxpayer's research credit for a tax year.

The rules, encapsulated in revisions made to the regulations of Section 41 also limit the availability of the ASC method via an amended return to members of a controlled group. In a given tax year, if any member of a controlled group claimed the R&D tax credit using a method other than the ASC method on its original return, no other taxpayer in the controlled group can claim the credit using the ASC method on an amended return for that year.

R&D Expenditures

As a result of IRS regulations issued on July 21, 2014, businesses may, in certain cases, benefit from expanded opportunities to deduct or amortize some of the costs of developing or building a product or piece of equipment.

NO DISTINCTION BETWEEN A NEW PRODUCT'S FAILURE OR SUCCESS

If your business expends resources to build a prototype or pilot model and those expenditures meet the IRS's R&D criteria, they qualify under Section 174 regardless of the prototype's outcome or final use. In other words, the expenses are eligible for the R&D tax credit regardless of whether the prototype succeeds or fails or whether you end up using it in your business or selling it to customers.

Here's an example of this type of Section 174 qualification, per the final 2014 regulations: Say a food and beverage



business designs a specialized piece of equipment for improving its bottling process. In an effort to remove uncertainty and evaluate different designs, the company develops a working pilot model at a cost of \$1 million. Whether the company later sells that prototype or uses it as a demo model in its business, the \$1 million in incurred costs qualify as R&D expenditures. Therefore, they could be eligible for deduction under Section 174.

DEPRECIABLE PROPERTY COSTS MAY BE ELIGIBLE

Under the depreciable property rule, expenditures for the acquisition or improvement of property subject to an allowance for depreciation or depletion aren't deductible under Section 174. However, depreciation deductions can qualify as Section 174 expenditures to the extent the depreciated property is used in connection with research and experimentation.

The final regulations clarify that the depreciable property rule is an application of the general definition of *research or experimental expenditures* and shouldn't be applied to exclude otherwise eligible expenditures.

COMPONENT PARTS

If you incur qualifying R&D costs to add a new component to an existing product, the costs associated with that particular component may qualify under Section 174— but not the costs associated with the original product.

The final 2014 regulations preserve Section 174 eligibility for certain component R&D costs even though the entire product may not be new. The IRS now refers to this as the “application of Section 174 to components of a product.” It was previously referred to as the shrinking-back rule.

For example, say you manufacture aircraft engines. You research and develop a new type of blade to improve an engine's performance, and to test the new blade's design, you produce the blade and install it on one of your existing engine designs. Because the blade design is new and you incurred R&D costs to resolve uncertainty about its function, it's considered a pilot model under Section 174 and is eligible for deduction. However, the costs of producing the engine—in which you tested the blade—aren't eligible, because uncertainty had already been removed from its development.

Internal-Use Software

Final regulations released on October 4, 2016, clarify what is and isn't internal use software (IUS).

Under these regulations, IUS development is subject to additional eligibility rules, referred to as the “higher threshold of innovation” tests, which go beyond the rules for non-IUS R&D activities. The final regulations expand and clarify the definition of IUS, opening the door for more software development activities to potentially qualify for the credit.

WHAT SOFTWARE IS ELIGIBLE?

To illustrate what types of software are now eligible to claim the credit without meeting the higher threshold-of-innovation requirements, the regulations use the example of an e-commerce website. In the past, the software that allows the site to manage orders and process transactions may have been subject to the IUS requirements, because it isn't licensed or sold to its users. Now, because the software users interact with that technology despite their not having purchased it, the software may not be considered IUS. Therefore, the activities involved in creating it wouldn't be subject to the higher threshold-of-innovation requirements.

Software development has traditionally been subject to more controversy than many other R&D activities. This is evident in the number of related court cases over the last few decades and the complexity of the IUS rules, which have been included in the IRS's priority guidance plan for the last few years.

Since the eligibility rules were first defined in the 1980s, software development has advanced in new directions, and the regulations have been slow to adapt. As a result, these changes should come as a welcome change for developers and others who perform software development in support of their other operations.



NEXT STEPS

Documentation Is Key

If you think you might claim the R&D tax credit now or in the future, start by documenting potential projects, namely products or processes, that may qualify. Evaluate all your company's activities for potential eligibility, then begin tracking qualifying expenses and gathering documentation to support the costs.

This will save you time and strengthen your claim if and when you decide to pursue the credit. It's worth the effort to get a process in place now, even if you're not in a position to take the credits immediately. Employees leave, memories fade, and documentation is lost with time—which means if you don't document your expenses now, you may lose the ability to claim them in future years.

There's another reason that documenting projects and expenses is important: Tax credits can attract investors and boost your company's value should you decide to sell in the future, because the credits may be passed on to the new owners. Note, however, that Section 382 limits the availability of R&D tax credits to an acquirer, so examine the specifics of your situation closely before making a decision about R&D tax credits based on that possibility.

To start, collect documents that:

- **Substantiate amounts**, including financial, tax, and payroll records
- **Provide nexus** between the amount and the activities performed, such as project accounting or time-tracking records
- **Identify and demonstrate qualified nature of activities**, such as development reports, patents, testing documentation

Documentation examples can also include employee time tracked to projects and time survey estimates based on contemporaneous documentation. Contemporaneous documentation can include project development notes, test reports, project designs, email communications, and mock-ups or models. For software development projects, it can also include information extracted from project management tools or code repositories that help demonstrate an iterative process of experimentation.

Documentation Tips

Retain notes, design revisions, and other support related to potentially qualifying projects in one place. By carefully separating expenses into those that may qualify for the R&D tax credit, companies can claim a lucrative opportunity as well as improve their financial position and clear the way for ongoing research.

Isolate and track expenses related to potential R&D activities in a manner that works for your business and accounting system. Many companies don't keep their books and records organized in the manner an IRS or state auditor will request. Engineers often don't want to be bothered with project time tracking or documentation of their qualifying work, but it's important to encourage these activities. For many companies, examination teams often focus on nexus—the connection between qualified research expenses and activities. Keeping books and records organized may not be on the top of your engineers' to-do lists (or yours) today, but it could pay to spend some time evaluating your R&D activities and costs and, more specifically, the documentation you have to support them.

Give due attention to contract agreements. For companies that conduct research under agreements with

customers or subcontractors, the IRS and state authorities are likely to request your contracts. That's to verify that your company bears the financial risk of those contracts—a necessary condition for R&D tax credit eligibility—and retains rights to any intellectual property developed.

Be particularly cautious if you plan to carry credits forward. Companies on the verge of profitability (or that have plans to sell or go public) may be particularly vulnerable to examination if they've claimed credits on their tax returns to carry forward and use later. Oftentimes companies in this situation haven't yet prepared the documentation they'll need when they start actively using the credits, and credits are typically scrutinized more closely once they're actually used to offset income tax.

In today's world of rapid technological development and change, R&D-qualifying activities are pervasive. As a result, companies need to stay on top of where they're investing valuable resources so they don't miss out on the credits available to them. Those savings are critical to fueling further innovation; in fact, studies show that 70% of credit dollars are used to pay the salaries of highly skilled engineers and to increase investment in R&D.

Seek Professional Advice

The R&D tax credit is a valuable opportunity to increase your cash flow. Still, it shouldn't come as a surprise that claiming the R&D tax credit and documenting your expenses can be complex.

Leveraging federal and state R&D tax incentives requires an understanding of IRS documentation requirements along with a technical understanding of the products and processes being put forward for credit claims. Further, the rules surrounding tax incentives keep changing, and many companies lack the resources to determine which of their activities could enable them to take advantage of the credits and current deductions.

Determining the true cost of R&D is often made even more difficult by the fact that few companies have project accounting systems that capture the cost of support provided by the various personnel who collaborate on R&D. Typical project-tracking systems don't include contractor fees, direct support costs, or the salaries of high-level personnel who participate in any given research effort. Most project accounting systems also aren't designed to track time or expenses to the specific activities or subcomponents of a project.

For these reasons, companies interested in claiming the R&D tax credit frequently work with an R&D tax credit services provider.

TYPICAL R&D SERVICE PROVIDER PROCESS

Before working with a R&D tax credit service provider, ask yourself whether that provider has:

- An established R&D tax credit practice with sufficient experience performing R&D tax credit studies and a good reputation
- Tax-experienced CPAs on staff who focus primarily on the R&D tax credit and its benefit to each shareholder
- Made a commitment to you to follow through and stand behind the R&D claim in the event of an IRS or state exam and any subsequent appeals
- Experience defending credits upon examination and a good working relationship with the IRS and state authorities
- A documented approach that includes spending time interviewing you and your staff
- A fixed fee (in accordance with Circular 230) or is trying to circumvent compliance by charging a percentage of the credits calculated

The Fee Structure Matters

With regard to the fee structure, spend time understanding how your R&D tax services provider proposes to charge you for its services and what the impact of such an arrangement would be. Circular 230, the set of IRS rules that govern what CPAs, attorneys, and other providers of tax advice must (and must not) do, prohibits tax preparers from performing R&D tax credit engagements under a contingency fee arrangement.

To get around this, some providers cap their fee based on calculated (anticipated) credits rather than actual credits received. The hourly rates associated with this fee structure are generally high when compared with those of other providers. The result is less work performed at a higher cost per hour. Even though this fee structure may provide IRS examination support once the cap is reached, no amount of the fee will be refunded to you if the credit is disallowed by the IRS during examination or is otherwise unusable.

By contrast, many firms will provide R&D tax credit services on an hourly or fixed-fee basis. This cost structure generally involves the provider creating a specific project plan customized to your individual needs. The total fees are generally lower than those based on a percentage of the credit. If your company is selected for IRS examination, exam support is generally also charged on a fixed-fee or hourly basis. However, exam costs can be negotiated as part of the R&D service engagement.

Whatever the fee structure, it's always important to secure hourly rates and a proposed scope from your service providers before selecting one.



CONCLUSION

If you think your company might be performing work that qualifies for the R&D tax credit, don't let the potential tax savings go unclaimed—and don't be intimidated by preconceived notions of what R&D is or what companies can qualify. Across industries, the possibilities for qualifying activities are out there, and if you're willing to take a look, you could uncover vital tax savings to reinvest in your business and fuel your next big project.

Learn More

To learn more about the credit and how much you might save, contact our R&D Tax Services professionals or visit us online.

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Acknowledgments

Special thanks to Travis Riley for sharing his insight and undertaking additional research to compile this guide. Travis has provided research tax credit studies to companies claiming R&D tax credits since 2006. He's a leader in the firm's R&D Tax Services group in California, helping both companies and business owners save millions of dollars in taxes each year.

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