

TAKING A BITE OUT OF TAXES WITH THE FEDERAL RESEARCH AND DEVELOPMENT TAX CREDIT



Many businesses, especially smaller ones, tend to dismiss the federal research and development (R&D) tax credit as either out of reach or too complicated. As a consequence, they lose out on potentially significant tax savings every year. When approached with a consistent, long-term strategy, the R&D tax credit can offset costs of a broad range of business processes and bolster a company's financial health.

Not Just for Traditional Research Industries

Almost every business does some sort of research or development work, though many don't realize it. The question isn't whether your industry is focused on R&D, but whether the activities you do to make your business better can qualify for the credit. Putting aside the technical requirements, which we'll get to later, the credit captures a surprising scope of activities. Here are a few examples of activities that qualify:

- » A manufacturing company engineering and testing new processes for custom products.
- » A processing plant figuring out how to optimize a new piece of equipment.
- » A food manufacturing company creating new food products.
- » A software company developing new applications and updating current applications.
- » A professional services firm developing a software tool for their client portal.

Once an activity qualifies for the credit, a business can claim substantial benefits. The biggest comes from the wages paid to employees who worked on the qualifying activity. Other





important categories include outside labor, supplies, and certain software costs. Taken together, converting these expenses into a tax credit can transform R&D work into a source of savings.

Key Qualifications for the R&D Tax Credit

The R&D tax credit has a reputation for being difficult to understand and navigate. Like so much of the tax code, the credit's rules can be stated in a simple way, but beneath the surface they have layers of complexity. One reason businesses hire firms like ours is to free internal staff from the detail work that goes into compliance with IRS requirements.

Activities must meet four tests before they may qualify for the R&D tax credit:

- 1. The Uncertainty Test.** At the start of the project the outcome must be unknown.
- 2. The Hard Sciences Test.** The process must fundamentally rely on the principles of science or engineering.
- 3. The Business Components Test.** The activity's costs must be associated with an identified part of the company's trade or business.
- 4. The Process of Experimentation Test.** One or more alternatives must be evaluated to achieve a desired result and eliminate uncertainty.

If an activity meets the four qualifications above, it also needs to be carefully documented. The documentation step is where many businesses lose out on the R&D credit. The IRS requires businesses to "clearly and reasonably" document the ways an activity meets the qualification requirements. Here is what the IRS Audit Technique Guide instructs auditors to look for when they review R&D tax credit claims:

Identifying the employees whose wages are claimed as QREs and determining the services they perform is perhaps the most important phase of auditing the research credit. Payroll records, employee job descriptions, performance evaluations, calendars and appointment books are good sources of information. The goal is to determine what the employee did and how much time they spent doing it.

A TALE OF TWO FOUNDRIES

Whittaker & Company works with two foundry businesses that in many ways are the same. They each produce large-scale metal components for similar customers. Each project they tackle is unique, requiring thoughtful engineering and extensive adjustments to their equipment. When we first began working with them, one of these companies had claimed the R&D tax credit for years. The other never had—because they didn't realize they were doing R&D work.





The documentation effort must begin before a new research process begins, and must continue throughout. Documents that are important to produce and keep include:

- Corporate governance records related to the project, such as meeting notes and board minutes.
- Contracts and receipts related to the activity.
- Internal reports about the activity, including interim reports and final documentation.

Major Benefits of the R&D Tax Credit

The R&D tax credit combines qualified expenses from four categories:

» Wages

Wages related to the qualifying activity often are the biggest expense category that can qualify for the credit. The credit can be claimed for wages paid to employees who were directly involved in the qualifying activity, as well as the wages paid to their direct managers. Startups can also use the R&D tax credit to offset payroll tax expenses for the first five years of operation.

» Outsourced research expenses.

Businesses that hire contractors to perform elements of their qualified activities can claim 65% of the expenses as an R&D credit. A few requirements must be met before contract research expenses qualify for the credit. First, the company must enter into the contract with the third-party provider prior to the start of the qualifying activity. Second, the company must own the results of the contractor's work. Finally, the company must be obligated to pay its contractor regardless of the outcome of the research.

» Supplies and materials.

Non-depreciable supplies that are purchased in connection with the qualified activity can be claimed as part of the credit. For businesses that must purchase expensive materials to conduct their experiments, this portion of the credit can have substantial benefits.

» Computing and software costs.

Today's research environment increasingly taps into the power of outsourced computing services. Whether hiring third-party servers to run simulations or subscribing to a software-as-a-service (SaaS) solution, this category can recapture significant costs.

The Benefits of Planning Ahead

The R&D tax credit is available to businesses that approach it with deliberation. It is not like other types of tax deductions, which can be retroactively characterized to fit within a particular strategy. The R&D tax credit's documentation and sequencing requirements mean activities





need to be undertaken with the credit in mind. Oftentimes this involves a shift in mindset when tracking cost attributable to projects.

In our experience, companies that begin using the R&D tax credit can see improved benefits over time. In the first year of claiming the credit, our goal is to coach our clients so they can understand and meet the credit's documentation requirements. Going into the second year and beyond, businesses can apply what they learned in the first year to deliberately comply with the documentation requirements. This helps them to capture more expenses and support a higher credit claim.

Our Process

Most businesses need professional help to get the most from the R&D tax credit. With coaching, care, and attention to detail, companies can begin to comply with the credit's requirements. The upfront investment to develop processes for claiming the credit fosters confidence that the business can move forward accounting for all the necessary details with the right discipline.

Whittaker & Company uses the R&D tax credit as one of dozens of strategies that, when combined, can save our clients substantial sums. We have a four-step process for establishing a sustainable program:

- » **Step 1: Conversations.** We begin with conversations to understand the client's current projects and to explore their experimental character. Our preliminary conversations focus on recent changes, such as a newly developed product, process, or system that might qualify for the tax credit.
- » **Step 2: Project qualifications.** With information in hand, our team will conduct a detailed analysis to identify potentially qualifying activities.
- » **Step 3: Project cost analysis.** We'll next review the details of each qualifying project, tying labor time and other expenses to specific qualifying activities. At this stage we also run tests to ensure our strategy will meet IRS guidelines.
- » **Step 4: Documentation.** We produce a detailed report that collects all the necessary documentation related to the R&D activity, so the company has everything it needs to respond to IRS requests.

With every engagement, our goal is to establish a process that will capture as many qualified expenses as possible. Are you ready to turn your company's R&D work into a tax benefit? Give Whittaker & Company a call to learn more about our process and to get started.

