

CFO Call Series

R&D TAX CREDIT

How to Optimize for Federal Government Tax Credit.



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R&D Tax Credit

An Overview

The R&D tax credit is available to U.S. companies developing new or improved business components, including tangible products, business processes, computer software, chemical formulas, inventions or techniques, that result in new or improved functionality, performance, efficiency, reliability, or quality, or some combination of each of these attributes.

The R&D tax credit is available to either reduce federal income taxes or it can be used as a refundable credit against payroll taxes. Additionally, over 30 states have enacted legislation to provide businesses with an R&D tax credit to be used to reduce or offset state income taxes.



R&D Tax Credit

Generally Not Included

- Research funded by another person, entity or governmental entity.
- Research adapting an existing product or process to a particular customer's need.
- Duplication of an existing product or process.
- Surveys or studies.
- Research conducted after the start of commercial production.
- Research relating to certain internal-use computer software
- Research conducted outside the US, Puerto Rico, or a U.S. possession.
- Research in the social sciences, arts, or humanities.



Qualified Research Activities ("QRA")

Each research activity must pass all four tests to be considered a QRA.

1. The activity involves the elimination of uncertainty concerning the development or improvement of a product ("**Sec 174 Test**")
2. The activity is useful in the development of a new or improved business component ("**Business Component Test**")
3. The activity discovers information that is technological ("**Discovery Test**")
4. The activity is experimental in nature ("**Process-of-experimentation Test**")



Qualified Research Expenditures ("QRE")

QREs are separated into four distinct categories as follows:

- (1) wages paid to employees or payments to contractors or owner-employees in connection with a QRA (**"Wage QREs"**)
- (2) supplies used in a QRA (**"Supplies QREs"**)
- (3) amounts paid to use computers (**"Computer Rental QREs"**) and;
- (4) amounts paid to third parties to perform research (**"Contract QREs"**).



SAMPLE WORKSHEET

01	Amounts paid to an energy consortia	--
02	Payments to qualified organizations	--
03	Qualified organization base period amount	--
04	Subtract line 03 from line 02, if \$0, enter \$0	\$0
05	Wages for qualified services	\$1,945,000
	+ Cost of supplies	\$285,000
	+ Rental or lease costs of computers	\$65,000
	+ Enter applicable % of contract research exp.	<u>\$213,000</u>
06	Total qualified research expenses	\$2,508,000

SAMPLE WORKSHEET - con't

07	Fixed-base %, but not >16%	3%
08	Average annual gross receipts	\$38,250
09	Multiply line 08 by % line 07	\$1,148
10	Subtract line 09 from line 06 "Total qual. Exp"	\$2,506,800
11	Multiple line 06 by 50%	\$1,254,000
12	Enter smaller of line 07 or 08	\$1,254,000
13	Add lines 01, 04 and 12	\$1,254,000
14	Multiple line 13 by 20%	\$250,800



SUMMARY

1. Determining if and how a potential QRE fits within a QRA is **not a simple exercise**. Furthermore, the number of QREs can be overwhelming to identify and analyze.
2. An **effective and efficient system** is needed and will typically be unique for each business.
3. Accounting classification treatment decisions directly impact and **potentially block** the qualification of a QRE.
4. **QRA timekeeping** for Wages QREs is almost always an essential component of the R&D tax credit system.

*For these reasons, **investment in an ongoing R&D tax credit system** is advised rather than treating the R&D tax credit like an afterthought during tax season when timelines are tight.*

DISCUSSION





Charles River CFO welcomes the opportunity to work with your company to provide part-time and interim CFO, accounting, tax, and human resource services.

We are smart, nimble, and flexible.

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