

Research and Development Tax Credit Myths that May be Costing You Money

written by Lauri Moon | October 12, 2016

(RSM Insight - Tom Windram: 9-30-16) The federal research and development (R&D) tax credit gives companies conducting qualified research the ability to generate a net research tax credit of 13 percent (9.1 percent under an alternative simplified method) of incremental qualified R&D spending* in order to lower their regular tax bill.

This credit can result in significant tax savings for manufacturing companies. However, *studies have shown that it is surprisingly under-claimed*. While nearly \$9 billion in R&D credits were claimed in 2010, National Science Foundation (1) statistics indicate that another \$4 billion in R&D credits could have been claimed but were not.

Manufacturing companies that develop new products, make improvements to existing products and develop or improve manufacturing processes are likely to qualify for the R&D credit. Middle market companies are among those least likely to take advantage of this beneficial credit.

The *Protecting Americans from Tax Hikes Act of 2015*, signed into law on Dec. 18, 2015, modifies and makes permanent the R&D tax credit. Eligible small businesses may now claim the credit against alternative minimum tax. Additionally, a small business start-up is now able to claim a credit of up to \$250,000 against its FICA payroll tax liability if it had less than \$5 million in gross receipts for the current taxable year and no gross receipts for any taxable year prior to the five-taxable-year period ending with the current taxable year. These modifications are retroactive to Jan. 1, 2015.

In our experience, many companies that have eligible activity erroneously disqualify themselves from claiming the R&D tax credit because of one or more of the

following assumptions:

Myth #1:	The R&D tax credit is only for companies that invent something revolutionary.
Reality:	The R&D tax credit is designed to encourage innovation. As such, it is equally available to companies that attempt evolutionary improvements to existing products or processes and companies that undertake revolutionary activities. The development or improvement effort does not have to equate to a moon shot. The regulations define research as activities constituting a process of experimentation “intended to eliminate uncertainty” based on information available to the taxpayer at the outset of the project. An experienced R&D tax professional can help you understand what types of activities meet the qualifying criteria.
Myth #2:	The R&D tax credit is only for companies engaged in basic research.
Reality:	The R&D tax credit also extends to applied science, something that many companies perform on a daily basis as they try to improve their business and production processes through the use of technology and science.
Myth #3:	The R&D tax credit is not available for companies that fail in their research.
Reality:	You do not have to be successful to claim the credit. The R&D tax credit is an efforts-based credit. In fact, the regulations specifically state that success is not required in order to be eligible.
Myth #4:	The R&D tax credit won’t help my company because my company is not profitable.

Reality:	It is true that the federal R&D tax credit is a credit against taxes, meaning you must be profitable to utilize the credit. However, the credit carries forward 20 years and back one year. Thus, it could be of immediate benefit if your company was profitable in the prior year and can be banked for use in future profitable years. Also, small start-up companies may now be able claim a credit against their payroll tax even if they pay no income tax. In addition, some state R&D credit programs provide for refundable credits.
Myth #5:	The R&D tax credit is only for big companies.
Reality:	While large companies may claim the biggest and most headline-grabbing credits, the program is open to all companies. There are no company size requirements; the credit is only based on engaging in qualified activities. The credit, however, must be actively claimed; it is not automatically granted. In 2010, more than 12,900 companies claimed the credit. Eleven percent, or 1,441, of these companies had business revenues below \$25,000, and 39 percent, or 5,015, companies had revenues below \$5 million.(2) In other words, approximately half of the companies that claim the federal research tax credit are considered mid-size companies or small businesses.
Myth #6:	The R&D tax credit is not available to my company because our research is funded by the government.
Reality:	This is an understandable misconception that invites deeper consideration. The R&D tax credit requires both technical uncertainty and financial risk. If a contract between the government (or other party) and the taxpayer requires the taxpayer to succeed or return funds, or to incur costs beyond what the government is paying, the taxpayer is at financial risk and thus eligible for the R&D tax credit. A determination can only be made by reviewing all of the contractual payment provisions. Taking the time for a thorough review usually proves rewarding.
Myth #7:	The R&D tax credit doesn't reduce state taxes.

Reality:	About two-thirds of states have an R&D credit program. As mentioned previously, some of these offer refundable credits, while others offer credits that can be carried forward. Most state eligibility requirements mimic federal eligibility requirements, though some may restrict, include or provide for enhanced credits for specific types of research. The most common differences between federal and state R&D credit computations relate to the credit rate and base amount computations.
Myth #8:	The R&D tax credit is not a big deal since my company is already getting a deduction.
Reality:	Smart tax planning includes taking advantage of all available benefits. An election under section 280C(c)(3) allows a taxpayer to take a reduced credit without disallowing the deduction for R&D expenses. Thus, a taxpayer may take a deduction for qualified R&D expenses in addition to a reduced credit at the tax-effected rate of 65 percent. The reduced credit is in addition to the deduction and represents a dollar-for-dollar reduction in regular income tax liability. Why leave money on the table and potentially put your business at a competitive disadvantage?
Myth #9:	The R&D tax credit is for increasing research; since my spending is flat, my company is not eligible.
Reality:	This is another tricky area full of misconceptions. The R&D credit does require an increase in research spending. However, current-year spending is compared to a base, which is 50 percent of the average spend for the prior three years, calculated under the ASC method*. In reality, your company's research spending could actually be decreasing, and your company could still be eligible for the credit.

If any of these nine assumptions have discouraged your business from claiming the benefits of the R&D tax credit, think again. It is not too late. Key owners of pass-through entities should be consulted as this would require extending their individual return filings as well.

Under some situations, businesses may also be able to amend prior-year tax returns and retroactively claim the credit. Amended returns will invite IRS scrutiny, and a

well-documented study is essential to sustain the refund claim. Additionally, many state claim periods are also open including some that offer refundable credits, meaning you don't even have to wait until you are profitable to see the dollars enhance your bottom line.

We recommend you work with your tax team and tax advisors and enlist them to take a look at your various business activities to see whether you qualify. By uncovering the truth behind a frequently misunderstood credit program, you may bring substantial dollars to your bottom line.

*Credit calculation note: The standard credit is 20 percent (13 percent under the reduced credit election) of the current-year qualified research expenses (QREs) over a historical base amount computed by applying a fixed-base percentage to the average of the prior four years' gross receipts. The fixed-base percentage is a function of aggregate QREs divided by gross receipts for the 1984 through 1988 base period. Companies that do not have QREs in at least three of the five base years use a start-up method based on a complex, five-year sliding scale formula. Under an alternative simplified credit (ASC) method, the credit is 14 percent (9.1 percent under the reduced credit election) of current-year qualified research expenses over 50 percent of the prior three years' QREs. Because the regular method can penalize companies whose R&D spending grows more slowly than revenues and the difficulties associated with documenting QREs in the base years, the ASC is often the more favorable approach.

(1) National Science Foundation, National Center for Science and Engineering Statistics; U.S. R&D Resumes Growth in 2011 and 2012, Ahead of the Pace of the Gross Domestic Product, Arlington, VA (NSF 14-307, December 2013). <http://www.nsf.gov/statistics/infbrief/nsf14307/>

(2) Statistics of Income Division: 2001 - 2010 Corporate Returns Data; Figure B. Corporations Claiming a Credit for Increasing Research Activities; Number of Credit Claimants by Size of Business Receipts; Tax Years 1990-2010

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