



How to Qualify for and Claim the R&D Tax Credit

What is the R&D tax credit?

The R&D tax credit was originally established in 1981 to incentivize innovative R&D across the United States. The 2015 Protecting Americans from Tax Hikes (PATH) Act made the R&D tax credit permanent, modified the benefit for small businesses, and made the credit available to startups. While the phrase “research and development” might call to mind white lab coats and groundbreaking discoveries, this credit can apply to a broad range of business activities.

“The truth is that qualifying for the credit is not complex,” said Tilstone. “Your company simply needs to be working to improve a product or process here in the U.S. There are a number of qualifying research activities (QRAs) that apply to thousands of businesses, including small and mid-sized, in countless industries.”

Unfortunately, Tilstone says, less than 3 in 10 businesses who qualify for the credit claim it, while virtually every large company makes the claim. Quite often, small

businesses leave significant amounts of money on the table because of common misconceptions about this particular credit.

What activities qualify for the R&D tax credit?

A business can claim two broad categories of activities towards the R&D tax credit: QRAs — sometimes called qualified research expenses (QREs) — and basic research payments. Most small businesses can claim expenses under the QRE category.

“For example, architecture firms can qualify for the credit by designing master plans or building systems, an everyday occurrence in the field,” said Tilstone. “Those in the software and tech industry can qualify by designing and implementing cloud-based IT solutions. Manufacturers can qualify for the credit when they develop second-generation products. The possibilities are endless, which makes the credit so flexible and valuable.”

Here are some other examples of activities that can go toward this credit:

- Developing or designing new products.

- Making enhancements to existing products or processes.

- Developing or improving upon existing prototypes and software.

- Streamlining manufacturing processes to increase automation or to reduce cost or waste.

- Refining techniques already in place, such as manufacturing, welding, drilling, etc.

- Advancing software to bridge or interface between outside entities (business-to-business or business-to-consumer) or internally with several systems.

- Services that are outsourced to external consultants.

How to claim the R&D tax credit

The IRS requires documentation to be submitted to back up your R&D tax credit claim. Experts recommend that you rigorously document any activities you wish to claim toward research to establish how much was spent on qualified research activities. The burden of proof lies with the taxpayer, so you should keep documents such as:

Payroll records for employees involved in R&D.

Expenses, receipts, and accounts for supplies and equipment related to R&D.

Contracts and invoices paid to any third-party partners involved in R&D.

Blueprints, patents, designs, drawings, and prototypes related to research.

Project and meeting notes related to research.

Tilstone strongly recommends partnering with a CPA or accountant to make sure you're eligible for this credit.

“More often than not we find that new clients have been under-claiming the credit, if they have taken it at all,” he said. “We have found that during this difficult period, small and mid-sized businesses have been able to use the capital from the credit as a lifeline to keep their doors open and pay their employees. It’s likely that your peers are using it in an attempt to get through this difficult time. The capital that businesses can bring in because of the credit can go toward any growth effort: hiring new employees, investing in new infrastructure, integrating new technologies to increase competition.”

Businesses looking to file their qualified R&D expenses need to complete Form 6765, which includes the following four sections:

Section A is for businesses claiming regular credit.

Section B is for the alternative simplified credit.

Section C recognizes additional forms and schedules.

Section D is for qualified small businesses that are making a payroll tax election.

The IRS suggests businesses calculate their credit using regular and simplified methods and then choose the section that offers the highest tax benefit.

For the 2024 tax-filing season, the IRS is considering significant changes to the R&D tax credit. If adopted, it could impose a substantial reporting burden on taxpayers seeking to claim this tax credit. Potential changes include the addition of a new Section E with five miscellaneous business questions and a new Section F asking for detailed information related to business components under Section 41 of the Internal Revenue Code.

The R&D tax credit claim process

Claiming the R&D tax credit can be done in three simple steps:

Study your R&D processes internally to identify the activities and their associated costs, which entails a thorough review of your financial records and business documents.

Build your case by collecting the necessary documentation to support your claim and complete the required forms that show the total expenses.

Apply for the credit by filling out Form 6765 and submitting it with your business's federal income tax return.

The qualifying four-part test

To determine whether your business qualifies for the federal R&D tax credit and its potential benefits, consider this four-part test under IRS Section 41.

Section 174 Test: Expenditures must be related to your trade or business, reducing uncertainty about development or improvement.

Discovering Technological Information Test: Your experimentation process must be grounded in physical or biological sciences, engineering, or computer science.

Business Component Test: Your business needs to have the intention of implying the discovered information to develop a new or improved business component, connecting the research to a relevant aspect of your business.

Experimentation Test: Your process should assess other methods or designs when the outcome is initially uncertain.

All four of these criteria must be met to qualify.

Eligible expenses

The R&D tax credit includes various expenses related to domestic labor, supplies, contracted services, and cloud computing when associated with product, software, or process development. Eligible labor includes wages for employees directly involved in the technical design, prototyping, testing, and supervision of a product. Certain supplies, like unrecovered raw materials used in R&D, are also eligible for the R&D tax credit. However, contracted expenses must involve the economic risk of the work and usually apply to development, engineering, and research contracts.

Types of businesses that are eligible

The R&D tax credit remains underutilized, primarily due to eligible businesses not fully understanding its potential. An estimated 14,000 businesses in the United States applied for the credit in 2022.

The credit is available for businesses of all sizes. Qualifications for this tax credit hinge on whether your company invested in activities recognized by the IRS as R&D, within industries like manufacturing, software, financial services, and agriculture commonly qualifying. Regardless of your industry, exploring this tax credit opportunity can optimize the financial performance of your business and lead to better resource allocation.

This article was originally written by Emily Heaslip.

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