TAXES

R&D Tax Credit Misconceptions and Guidelines

With all the benefits of the R&D Tax Credit, some are looking for clarification on the best the procedures for acquiring the credit and applying it.

Feb. 03, 2023

By Steven Bright, ADP vice president of Business Incentives.

The federal research and development (R&D) Tax Credit is a useful credit for businesses of all sizes. The credit is designed to help organizations that engage in a range of activities, such as develop new products, processes, software, and more. In addition to providing a dollar-for-dollar reduction in a company's tax liability, it also actively encourages a culture of innovation as business managers continue to put a high emphasis on development.

With all the benefits of the R&D Tax Credit, some are looking for clarification on the best the procedures for acquiring the credit and applying it. So below are some important areas to consider, along with some common mistakes, to make sure your business can fully use these tax credits to support their organizations.

Only Qualified Activities Count

A common misconception about the R&D Tax Credit surrounds the types of activities of that qualify for the credit. Only qualified research and development activities, as defined by the IRS are eligible to count towards the credit. To determine this, the IRS uses the following four-part test where the activity must meet the following criteria.

1. The activity must be related to developing or improving the functionality, quality, reliability or performance of a product, process, formula, technique or software.
2. The business component's development must be based on the principles of a hard science, such as engineering, physics and chemistry, or the life, biological or computer sciences.
3. The organization must have faced technological uncertainty when designing or developing the product, process, formula, technique or software.
4. The company must have evaluated multiple design alternatives or employed a systematic trial and error approach to overcome the technological uncertainties.

Enforcement

To keep certain regulatory standards and to ensure proper allocation of funds, the IRS has penalties in place to make sure businesses are compliant. For example, in situations where expenses are incorrectly classified as R&D expenses to claim the tax credits, the IRS can disallow the credits. Though rare, R&D credits that are egregiously overstated in blatant disregard of the controlling law may even be subject to penalties and fines of up to 20% of the overstatement.

As a business manager, the easiest way to avoid putting yourself in a precarious situation is to ensure that all research activities that you plan to claim for tax credit fulfill all the criteria outlined above. Consulting with tax experts who are well versed with the R&D Tax Credit will help organizations maintain compliance.

No Business is Too Small

A key for businesses of all sizes to keep in mind about claiming the R&D tax credit is that organizations can be large or small to claim the credit, and size doesn't impact how much an organization can claim. In reality, the size of the tax credit is based on the qualified R&D spending that an organization records and not the size of the business' payroll or receipts.

Furthermore, many organizations choose not to claim R&D credits because they believe that their research isn't eligible. If a project meets the criteria defined above for a qualified activity, eligible expense tied to that project are includable in the credit calculation even if the project is ultimately unsuccessful. Whether it's developing IP or redesigning a product, the scale of the project is irrelevant to qualifying for the credit.

Navigating different tax credits can be a complicated and difficult process for organizations. But developing a better understanding of tax credits like the federal research and development credit, can help your business significantly in the long run.

Benefits • Income Tax • IRS • Taxes