



Eye On Washington

Legislative Update



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Legislative Trends: Understanding Tax Credits, Part 2: Research & Development Tax Credits

Eye on Washington's new series focuses on the latest HR regulatory trends taking place at the federal, state, and local levels. Topics include payroll tax and HR compliance, Health Care Reform, payroll, benefits, leaves, reporting obligations and more.

The federal government offers several tax credits to help eligible businesses lower their tax liability. Federal tax credits include the Work Opportunity Tax Credit (WOTC), the Empowerment Zone Employment Credit and the Indian Employment Credit. Other federal incentives are available through economic development credits. Additionally, many states offer tax credits and incentives that focus on training, growth, and new employment. Finding available tax credits and incentives for which your business is eligible mainly touches upon the disciplines of tax, accounting, legal and HR, but it can also impact hiring managers. Deciding where to open a new retail, service or manufacturing facility, for instance, should involve a close look at potential tax credits.

In Part One of our series, we focused on the federal tax credit, [Work Opportunity Tax Credit \(WOTC\)](#). For Part Two, we'll focus on a largely overlooked and underutilized tax credit – the research and development ("R&D") tax credits – that are available under federal and state laws.

Background

The R&D tax credit is a federal tax credit (the "R&D Credit") designed to encourage investment in the development and/or improvement of products, manufacturing processes, and certain technologies in the United States (I.R.C. Sections 38 and 41). Originally a temporary credit, the R&D Credit was permanently extended at the end of 2015 and was also expanded to offer a reduction in tax liability for many small-to-medium-sized companies, which previously may have been unable to take advantage of the R&D Credit.

In addition to the federal R&D Credit, many states offer R&D tax credits for qualifying research activities performed within their borders. Several states also allow for the R&D tax credits to be sold or refunded, which can be a significant benefit.

Impact to Employers: Determining Qualified Research Activities Under Federal Law

The definition of what R&D activities and costs qualify for the federal R&D Credit is much broader and more comprehensive than many companies realize. Broadly stated, a company may be conducting qualifying R&D activities for purposes of the R&D Credit if they have invested time and resources into attempting to create or improve a product, process, method, technique, formula, invention, or software application within the United States.

While not an exhaustive list, here are a few examples of R&D activities that generally qualify:

- Developing or designing new products, processes, formulations, or systems
- Developing prototypes or pilot models
- Modifying or redesigning existing processes or systems

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- Researching product and material alternatives/substitutions
- Developing new or improved manufacturing processes
- Developing or applying for patents regarding products or processes that are being developed in the United States
- Directly supporting or supervising research activities
- Developing internal software solutions and/or applications

Qualified federal R&D research activities are those activities that meet the following general “four-part” test:

Permitted Purpose (IRC §41)	Technological in Nature (IRC §41)
<p>The activity must relate to a new/improved business component*:</p> <ul style="list-style-type: none"> • Function • Performance • Reliability and/or • Quality 	<p>The activity performed must fundamentally rely on principles of:</p> <ul style="list-style-type: none"> • Physical or Biological Science • Engineering and/or • Computer Science
Elimination of Uncertainty (IRC §174)	Process of Experimentation (IRC §41)
<p>The activity must be intended to discover information to eliminate uncertainty concerning the:</p> <ul style="list-style-type: none"> • Capability • Method and/or • Design for developing or improving a business component* 	<p>The taxpayer must engage in an evaluative process that is capable of identifying and evaluating one or more alternatives to achieve a result.</p> <ul style="list-style-type: none"> • This may include modeling, simulation, or a systematic trial-and-error methodology.

* A business component includes any product, process, computer software, technique, formula, or invention which is to be (A) held for sale, lease, or license, or (B) used by the taxpayer in a trade or business of the taxpayer.

Determining Qualified R&D Expenses

The R&D expenses eligible for the federal R&D Credit are called Qualified Research Expenses (QREs) and are defined as the sum of in-house research expenses and contract research expenses. These expenses generally include:

- **Wages** – This number includes the wages of personnel directly involved in, supervising or supporting qualified R&D activities. If an individual spends 80% or more of their time working on the qualified R&D activities, then 100% of their wages are counted when calculating the

R&D Credit. If the percentage of time spent is less than 80%, then the actual percentage of time the individual spends on qualified R&D activities is multiplied by his or her salary and allocated.

- **Supplies** – Most tangible personal property used or consumed during the qualified R&D activity (excluding land, land improvements, and other depreciable property).
- **Contract Research** – A percentage of amounts paid to contractors brought in to assist with the qualified R&D activity (depending on the type of vendor, amounts are limited to 65%/75%/100%).



Eye On Washington

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State R&D Tax Credits

Generally, the definition of qualified R&D in each state is based on federal tax credit regulations; however, the value of these credits and other factors vary from state to state.

States can have different methodologies for calculating R&D credit amounts and varying approaches to providing tax benefits to startups or companies with net operating losses. For companies operating in multiple states, it can be easy to miss out on this crucial tax benefit, so employers should work closely with their tax credits team to help ensure they are receiving the maximum R&D tax credits for which they are eligible.

Monetizing R&D Tax Credits

R&D Credits can be monetized in a variety of ways. For example, a corporate taxpayer would include two additional forms with their federal income tax return, and the R&D Credit will directly reduce the tax liability for that corporate taxpayer on that federal income tax return. For those small companies that are eligible to offset payroll tax liability, the payroll tax offset would be claimed beginning on the payroll tax filing for the

quarter immediately following the date of the company's federal income tax filing. Additionally, some state credits may be sellable or refundable for companies that have no tax liability in that geography.

It's important to note that federal taxpayers can also claim the R&D Credit retroactively by filing amended returns for the past three tax years (or more if your company endured losses during that time). This can be a good way to recoup taxes previously paid. In addition, state taxpayers may also be able to amend returns that go back even further.

We recommend that employers continue to work closely with their tax credits team to help ensure all necessary supporting documentation is being submitted in a timely manner.

For more information on the R&D tax credit, register for the September 28th webinar, [Fact or Fiction? The Truth About Research & Development Tax Credits](#).

ADP Compliance Resources

ADP maintains a staff of dedicated professionals who carefully monitor federal and state legislative and regulatory measures affecting employment-related human resource, payroll, tax and benefits administration, and help ensure that ADP systems are updated as relevant laws evolve. For the latest on how federal and state tax law changes may impact your business, visit the ADP *Eye on Washington* Web page located at www.adp.com/regulatorynews.

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