

Secrets for Claiming the R&D Tax Credit



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A man walks into the Internal Revenue Service building in Washington, DC on March 10, 2016. / AFP / Andrew Caballero-Reynolds (Photo credit should read ANDREW CABALLERO-REYNOLDS/AFP/Getty Images)

There are plenty of myths and urban legends about the R&D Tax Credit – such as that it's only for large companies or for certain industries. But listening to this kind of talk could be a big mistake. The fact is that the R&D tax credit is quite broad. Oh and yes, it can be a big tax saver. In fact, over the years, I've helped companies get these benefits.

So what are some of the factors to keep in mind? First of all, you must meet a four-part test, which includes the following:

Elimination of Uncertainty: You need to show that you have made attempts to eliminate the uncertainty about the development or improvement of the product or process. For the most part, this means that you need to go beyond just making cosmetic changes.

Process of Experimentation: The activities must involve experimentation, say with simulations, modeling or hypothesis testing.

Technological in Nature: The activities must be based on sound principles of science or engineering.

Permitted Purposes: There must be some type of improvement, whether in performance, quality or reliability.

Okay then, what are the kinds of things that qualify? Well, just some of the examples include software development (whether for sale or for internal purposes), design tools, dies, molds, patents, certification testing, environmental testing and automated manufacturing processes. Although, there are some items that are specifically excluded like consumer surveys, management studies, acquisition of patents or models, ordinary testing or inspections and efficiency surveys.

Once you have determined that your innovation is eligible, you then need to understand what expenses qualify. So here's a breakdown:

- Salaries: These are for those who directly work on the innovation and also for first-line managers.
- Legal Fees: This would be for a patent.
- US-Based Contractor Fees
- Supplies

The Tax Benefits

Keep in mind that the R&D Tax Credit is nonrefundable (your state may also offer a credit). This means that you can reduce your tax liability dollar-for-dollar. However, if you have no taxes owed, then you will not be able to use the credit.

Yet you should still keep track of your R&D expenses anyway. The reason: The IRS allows you to carry forward them up to 20 years. What's more, you can carry back the expenses for three years. In other words, you may be able to get a refund by filing an amended return.

Something else: smaller companies can get a payroll tax offset. That is, you can get the R&D Tax credit even if you do not owe any taxes! This is actually up to \$250,000 of payroll.

To be eligible, your company must have:

- Gross receipts for five years or less
- The average gross receipts is no more than \$5 million within the last five years

And finally, when it comes to the R&D Tax Credit, you need to be diligent with your recordkeeping. Make sure you keep the documentation of your projects, such as emails, billings, payroll records, specs, project timelines, diagrams, drawings, flowcharts, meeting schedules and so on. If not, you could wind up being in a bad spot if you get targeted by the IRS for an audit.

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