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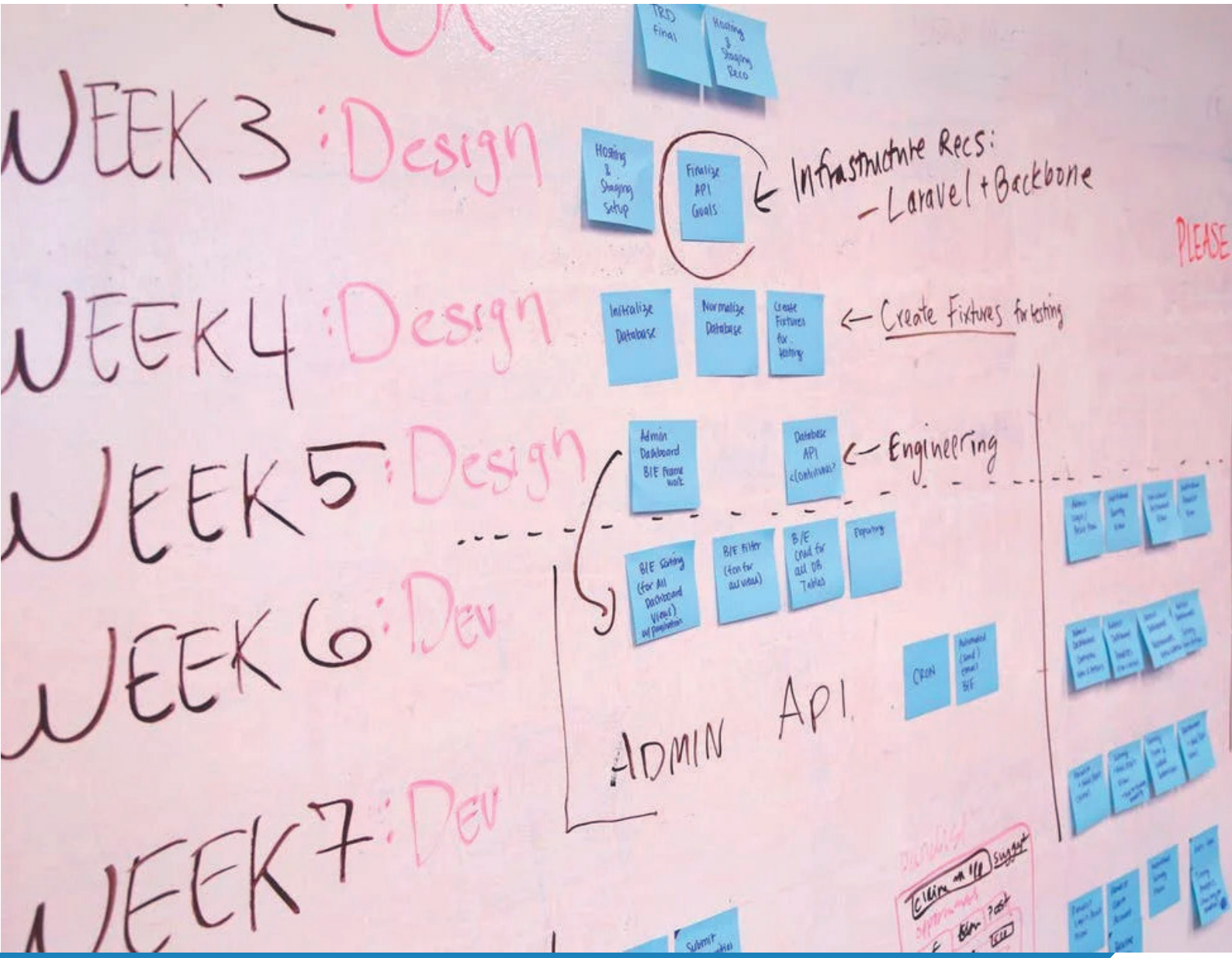

Research and Development Tax Credit

Investment in research and development is an important component of remaining competitive and driving more revenue for a company. While most companies expense the cost of R&D activities, most fail to take advantage of the research and development tax credit.

R&D tax credits incentivize companies to invest in innovative activities by allowing them to claim a tax credit based on qualified expenditures related to research and development. While the R&D tax credit is for federal tax liabilities, many states also provide R&D tax credits.

R&D tax credits reduce a company's federal tax liability dollar-for-dollar and can be carried back one year or forward for up to 20 years.

Small to mid-size businesses can elect to use the tax credit to offset up to $250,000 in payroll taxes each year for up to five years, provided they meet certain requirements. To qualify, businesses must be under five years old and have gross receipts of less than $5 million.

Offsetting payroll taxes can be particularly beneficial for start-up companies and companies that don't have a tax liability.Start-ups often invest in research and development but rarely generate enough profit to make the tax credits worthwhile. Yet, these businesses still have payroll taxes, so the ability to offset payroll taxes offers an immediate benefit.

To qualify for the credit, a company must perform certain types of activities like developing new products, improving existing products, or finding new ways to manufacture products. The IRS has provided a four-part test to help determine if a business's research and development activities are eligible.

First, the R&D must be conducted to eliminate uncertainty about a product. R&D for aesthetic or cosmetic purposes will not qualify for the credit.

Second, the R&D must produce some form of improvement in performance, quality, function, or reliability.

Third, the process must include experimentation. This may be shown with models, hypotheses, or other scientific methods.

And fourth, the activities must be based on science or engineering and not social sciences. Though many R&D activities qualify for the credit, certain activities and products are specifically excluded such as consumer surveys, routine data collection, and ordinary inspections.

The tax credit is based on expenditures for qualifying activities, which must meet certain requirements set forth by Section 41 of the Tax Code. In general, four categories of expenses qualify: salaries, legal fees, contractor fees, and supplies.

The tax credit amount is typically worth 5 to 10 cents for every dollar of qualified expenses. For example, a small business that spends $100,000 on qualified research and development activities may receive a federal tax credit of $5,000 to $10,000.

Businesses claiming the credit must keep detailed records of their activities and expenses. Specifically, businesses need to report all research activities performed and identify the individuals who performed each activity, along with what they sought to discover on Form 6765 Credit for Increasing Research Activities. This amount of documentation may seem onerous, but for many businesses, it's a worthwhile endeavor for the tax credits.

Final Thoughts

While the R&D tax credit can be significant for many businesses, there are many rules and guidelines that must be followed to ensure tax code compliance.

This document is intended to provide a brief overview of R&D tax credits and is not a substitute for speaking with one of our expert advisors. Please contact our office for more information if you'd like to learn more about the R&D tax credits and whether your business is eligible.

About Cain Ellsworth.

Cain Ellsworth is not all things to all people. Instead, we specialize in serving small to medium businesses in banking, manufacturing, property and casualty insurance, plus a variety of other industries. And we dedicate significant resources to assure that we are well-informed in each of them.

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