

Overview of the R&D tax credit:

IRC Section 41 provides a tax credit for increasing research activities. Per Section 41(d)(1), the term “qualified research” means research -

- A. With respect to which expenditures may be treated as expenses under section 174,
- B. Which is undertaken for the purpose of discovering information— (i) which is technological in nature, and (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
- C. Substantially all of the activities of which constitute elements of a process of experimentation

All qualifying research expenses are subject to a four-part test. This test includes:

- 1. The expense must qualify as a research expense under IRC Section 174. This expenditure must be incurred in connection with a taxpayer’s trade or business or represent a research or experimental cost in the experimental or laboratory sense. Expenses qualify when they are incurred as a result of activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer at the time is not enough for them to establish a method of developing or improving a product or process.
- 2. The expense must be incurred during a process of experimentation that is technological in nature, fundamentally relying on the principles of Engineering, Physical Science, Computer Science, or the traditional sciences.
- 3. The expense must be incurred during the development of a new or improved business component. A business component is any product, process, computer software, technique, formula, or invention which is held for sale, lease, or license or which is used in a trade or business of the taxpayer. This can include the function, performance, reliability, quality, efficiency, or effectiveness of the business components.
- 4. There must be a process of experimentation. This is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the design of the result, is uncertain as of the beginning of the taxpayer’s research or experimental activities. This can include trial and error, computer modeling of designs, and testing mock-ups.

The following activities are not qualified research activities per IRC Section 41(d)(4):

- (A) Research after commercial production - Any research conducted after the beginning of commercial production of the business component.
- (B) Adaptation of existing business components - Any research related to the adaptation of an existing business component to a particular customer’s requirement or need.
- (C) Duplication of existing business component - Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.
- (D) Surveys, studies, etc. Any—
 - i. efficiency survey,
 - ii. activity relating to management function or technique,

- iii. market research, testing, or development (including advertising or promotions),
 - iv. routine data collection, or
 - v. routine or ordinary testing or inspection for quality control.
- (E) Computer software - Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in—
- i. an activity which constitutes qualified research (determined with regard to this subparagraph), or
 - ii. a production process with respect to which the requirements of paragraph (1) are met.
- (F) Foreign research - Any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.
- (G) Social sciences, etc. - Any research in the social sciences, arts, or humanities.
- (H) Funded research - Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Qualified Research Expenses (QREs)

IRC Section 41 (b)(1) provides that the term “qualified research expenses” means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer— in-house research expenses and contract research expenses. IRC Section 41(b)(2) defines in-house research expenses to be:

- i. Any wages paid or incurred to an employee for qualified services performed by such employee
- ii. Any amount paid or incurred for supplies used in the conduct of qualified research

Contract research expenses are calculated at 65% of any amount paid or incurred by the taxpayer to any person (or company), other than an employee of the taxpayer, for qualified research.