What is the R&D Tax Credit?

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The R&D tax credit is a general business tax credit under Internal Revenue Code Section 41. It's the largest of the annual tax credits that are potentially available to U.S. companies that pursue innovation with increasing investment.

The federal credit is calculated based on a company's increases in research activities and expenditures. It can be a reduction of tax liabilities, or a payroll tax offset, for taxpayers that design, develop, or improve products or processes, techniques, formulas, or software.

The R&D Tax Credit Evolution

1981: The R&D tax credit was first introduced in the United States in 1981 in the Economic Recovery Act, sponsored by U.S. Rep. Jack Kemp and US Sen. William Roth. It was created in reaction to a perceived economic slowdown and commonplace job outsourcing. Originally, the credit was set to expire in 1985. In fact, over the years, it's been set to expire eight times and it was extended 15 times. The last extension expired on December 31, 2014. The credit was made permanent in 2015.

2003: The credit was limited to companies that created or produced a product or process that was new to the world, according to the "Discovery Rule." In 2003, the United States eliminated the Discovery Rule and expanded what activities could qualify for the R&D tax credit. No longer did a company have to create something new to the world, but only new to the taxpayer, lowering the threshold to qualify and opening the credit's availability to new industries.

2006: In 2006, the alternative simplified credit (ASC) was enacted. It offered companies more flexibility in calculating credit amounts and the ability to change the baseline calculations for the credit.

2014: In 2014, Section 174 regulations were put into effect. Section 174 changes the way controlled-group credits are allocated among members. It also says that if supply costs are incurred for the development of a pilot model, the ultimate disposition of the pilot model is irrelevant. Also, temporary regulations allowed ASC on amended returns for years that taxpayers had not previously claimed a credit.

2015: In 2015, the US government passed the Protecting Americans from Tax Hikes Act, making the R&D tax credit permanent. Companies with $50 million or less in gross receipts were now able to apply the tax credit against the alternative minimum tax (AMT).

2018: In 2018, the Tax Cuts and Jobs Act (TCJA) reduced the corporate tax rate from 35% to 21%. Taxpayers claiming a reduced tax rate began to see an increase in their credit.

2021: Today's R&D Tax Credit

Ways to Utilize the Credit

- Use against AMT
- Against past or future tax years
- Dollar-for-dollar benefit
- Refunds
- Against payroll taxes
- Deduct or amortize the cost of R&D expenses

So where does all that leave us? It's time to stop thinking about the 1981 version of the R&D tax credit that you once knew.

The R&D tax credit available today is the best way for a taxpayer to reduce its tax liability for doing business as usual. The credit rewards improvement as much as it does innovation. It's open to more companies than ever before, even start-ups that aren't profiting, as it allows them to apply the credit against the payroll tax. The credit has expanded to reward more taxpayers. If you didn't qualify in the past, you could still qualify today. Failure doesn't preclude a company from claiming the R&D incentives.

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More Work to Do

The United States ranks 24th in tax support for R&D. It ranks eighth among OECD countries in federal R&D spending as a share of gross domestic product. Economists say the optimal amount of R&D investment is three to four times higher than the current level. Experts are recognizing that they can incentivize even more than they have been, and there are many proposals in Congress to expand the credit.

The CHIPS for America Act

The Creating Helpful Incentives to Produce Semiconductors for America Act, otherwise known as **The CHIPS for America Act**, brings chip manufacturing home. In late December 2020, Congress passed the bipartisan legislation that would invest billions of dollars in semiconductor manufacturing incentives and research initiatives over the next five to 10 years to strengthen American leadership in chip technology.

The legislation offers a 40% refundable income tax credit for semiconductor equipment or manufacturing-facility investment through 2024. It tapers off by 2028. It's a $10 billion federal program that matches state and local incentives made for the establishment of a foundry with advanced manufacturing capabilities. The bill promises $12 billion in R&D funding to be allocated over the next five to 10 years.

The FORWARD Act

The Funding Our Recovery With American Research & Development Act (**The FORWARD Act**), introduced in May 2019, expands access to the R&D credit and covers worker training costs. It improves access to the credit, as companies with up to $20 million in gross receipts will be able to use it to reduce payroll taxes over eight years -- up from $5 million and five years. The eight-year window starts when gross receipts exceed $25,000.

In regard to R&D by domestic manufacturers, the credit rate is increased to 25% and 17.5% for the regular research credit calculation method (RRC) and ASC, respectively. The act supports the credit by providing outreach, education, and training for businesses with limited accounting expertise.

Proposal to Double the Tax Credit

In July of 2020, U.S. Rep. Jackie Walorski introduced legislation to double the R&D tax credit and allow more small business start-ups to access the credit.

This bill would double the traditional credit from 20% to 40% of the increase in R&D spending, double the ASC from 14% to 28% of the increase in R&D spending, more than double the credit for firms with little research history (past three years) from 6% to 14% of the R&D spending. Companies with low income over the past five years could take credit against the Social Security payroll tax, as well. The bill also doubles the limit on the amount companies can claim from $250,000 to $500,000.

The American Innovation and Competitiveness Act

The American Innovation and Competitiveness Act, which Representatives John Larson and Ron Estes introduced in September 2019, restores immediate R&D expensing. The act allows taxpayers to monetize immediately and not carry forward; it repeals the amortization over five years of research and experimental expenditures provision within TCJA.

The Commitment to American Growth Act

The Commitment to American Growth Act, introduced in October 2020 by Reps. Kevin Brady and Kevin McCarthy, covers the above proposals, lets start-ups deduct a certain amount in start-up costs, and offers special incentives to the medical and pharmaceutical industries.

Specifically, the act doubles the credit and cancels the five-year amortization law. It also expands the credit so start-ups can offset up to $500,000 in payroll taxes, allows start-ups to deduct $20,000 in start-up costs, and widens the alternative simplified credit. The American Growth Act plans to loosen limitations for net operating losses, and after an ownership change, when tax attributes arise in the start-up period. It also permits companies developing intellectual property abroad to bring it back home without any tax liability (although it will be taxed when the intellectual property is sold).

The act targets medical-supply and pharmaceutical companies. The Domestic Medical and Drug Manufacturing Credit offers a 10.5% credit on net income from the sale of active pharmaceutical ingredients and medicines; the Temporary Advanced Manufacturing Credit features a 30% credit for new investments in machinery for medicine or medical supplies that will be manufactured in the United States; it allows companies that are “pre-revenue” to collect an R&D tax credit refund, and it permits companies that have qualifying research expenditures associated with infectious disease to receive a 14% bonus credit on top of the regular R&D tax credit.

Who Qualifies Now for the R&D Tax Credit: Industries, Activities, and Expenses

The R&D tax credit rewards improvement as well as innovation. Unless you've been making products, or processes, exactly the same way since your business began, there's a good chance your business activities qualify for the R&D tax credit in the United States.

You qualify if: you've developed or designed new products or processes, enhanced existing products or processes, or developed new–or improved upon–existing formulas or software, as well as filed for any patents.

Agriculture

- Developments and implementation of irrigation systems
- Development of new disease-resistant crops or livestock
- New ways to prevent or control insect pests

Manufacturing

- Developing innovative equipment
- Developing second-generation or used products
- Tooling and equipment design and development

Software and Technology

Software applications for any industry might qualify:

- Accounting and finance software
- Document managing systems
- Educational software

Architecture

- Developing unique energy-efficient building envelopes
- Designing master plans, building systems, site orientations
- Developing schematic designs
- Developing planning and elevation drawings to overcome site features

Construction

- Designing LEED/green initiatives
- Performing request for information process
- Designing HVAC systems

Engineering

- Determining alternative materials to construct something
- Developing alternative water flow
- Improving or determining alternative heating systems

Why Don’t More Companies Apply?

Only five percent of companies that qualify apply for the credit. Some companies don’t apply because they think they won’t qualify—often, they are wrong. Some think the process is too complicated, or that the cost of applying is too expensive and won’t justify the credit.

Many also assume certain industries don’t qualify or presume that unless they have an “earth-shattering” invention, they don’t qualify. There's also a lack of information about the credit: Many companies think if they’re not paying federal income tax/not profitable, then there is no benefit. Then there are taxpayers who think they don’t have the time to track documents or go through the hoops of claiming the credit due to understaffed tax departments. But thanks to technology, those reasons no longer have legs as R&D tax credit software can streamline the process and allow companies to make claiming R&D tax credits a cost-effective in-house job.

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The Director of R&D Tax Incentives at CrossBorder Solutions, Rahim Walji leads the Professional Services Group consisting of tax and industry experts supporting customers through the implementation of CrossBorder Solutions' R&D software suite. He also contributes to enhancing the company's market-leading R&D technology. A government compliance attorney and R&D tax expert, Walji has leveraged his breadth of legal and corporate tax compliance experience to help companies of all sizes and in various industries maximize their R&D tax credit benefits. Contact him at Rahim.Walji@xbs.ai.

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CrossBorder Solutions is backed by Insight Partners, the leading private equity firm in the world. We have achieved a billion-dollar valuation and raised over $100M in growth capital to date. These investments are leveraged to continue to develop and maintain Fiona, our proprietary AI engine, and expand global operations to serve a diverse and growing client base.

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