

DRIVEN TO SUCCEED

The ultimate guide to navigating R&D tax credits

Always Designing for People®

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INTRODUCTION

The road to the federal Research and Development ("R&D") tax credit is like any other journey. It's filled with bumps, detours and delays. At ADP, we strive to make the journey as smooth as possible. Think of us as the engine that gets you where you're going.

START YOUR JOURNEY
A look at the R&D tax credit

PASSING THE TOLL
A look at the R&D tax credit

COMPACT VEHICLES
Startups and small-to-midsize businesses

THE DESTINATION
Claiming the R&D tax credit

WHY ADP
Rev your engine with ADP



How is the R&D tax credit different than a typical write-off?

Typically, write-offs are expenses that lower your taxable income. The R&D tax credit reduces your tax liability — dollar for dollar. If you have $5 million in R&D tax credits, you'll have $5 million less in liability.

R&D JOURNEY

START YOUR JOURNEY: A LOOK AT THE R&D TAX CREDIT

When you manually extract, transform, validate, format and submit data to multiple agencies, the risks of data errors grow exponentially. These errors may translate into penalties and interest. That creates an additional burden for staff to manage while trying to keep normal workflows going.

The road to success is paved with opportunities. One of the most significant — and, maybe, the most often overlooked — is the federal R&D tax credit. What is the R&D tax credit? Simply put, it's an incentive for companies to invest in research and development. In practical terms, it's a way to reduce income tax liabilities with a credit calculated from qualified R&D-related expenses — dollar for dollar. Unfortunately, a lot of companies don't claim this valuable credit on a federal or state level. They either assume the credit doesn't apply to them, or that claiming it isn't worth the time.

Are you leaving money on the table?



43%

of businesses say they are already claiming the R&D tax credit.[1] Why aren't you?

$12B

Every year, more than 100,000 businesses claim over $12 billion in federal R&D tax credits.[2]

1. Fact or Fiction: The Truth About Research & Development Tax Credits, ADP, September 2017
2. ADP Webinar Poll, 2017

PASSING THE TOLL: ARE YOU ELIGIBLE?

The federal R&D tax credit applies to any company developing new or improved products, processes, software, techniques, formulas or inventions — regardless of industry.

If you can answer "yes" to the following four questions, your company may qualify.

1. **Are you engaging in an experimental process?**
2. **Are you out to eliminate technical uncertainty?**
3. **Do your R&D activities relate to the sciences, such as physics, biology, engineering or computer science?**
4. **Are you developing a new or improved product, process or component of your business?**



Keep your eyes on the road!

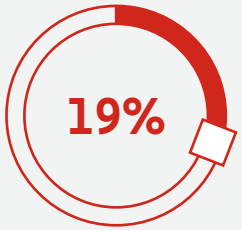
Activities that may qualify for the R&D tax credit include the development of:

- Products
- Processes
- Software
- Formulas
- Techniques
- Inventions

Check your route

Businesses in many industries receive the federal R&D tax credit. Does yours?

- Biotechnology
- Engineering
- Healthcare
- Manufacturing
- Pharmaceuticals
- Software



The software industry drives nearly **19%** of all global R&D spending.[3]



Manufacturing is responsible for **70%** of private sector R&D spending.[4]

3. Statista, 2023
4. IBIS World Industry Statistics, Manufacturing in the United States 2005–2029



What's a qualified expense?

If your business is eligible for the tax credit, you can **offset your tax liabilities** with the following expenses (when they're related to qualified R&D activities performed in the United States):

- **Wages paid to employees** performing the R&D activities
- **Supplies** (tangible, raw materials) used to conduct the activities
- **Cloud computing expenses** used to develop qualified software
- **Amounts paid to contractors** involved in the R&D activities

Do all employee wages qualify for the credit?

Many wages qualify, but not all. To qualify, the wages must be paid to an employee who is conducting, directly supervising or directly supporting appropriate research activity. Only the time attributable to those activities may be claimed.

Do payments to contractors qualify?

Yes! If your company pays a third party to conduct research activities, you may be able to claim up to 65% of that expense. But, to qualify, your business needs to maintain substantial rights to the research and bear the financial risk of failure. (That is, you owe the money whether or not the research is successful.)

Which computer costs are qualified expenses?

You can claim cloud hosting services that were specifically used when coding or testing new or improved software.

$83B

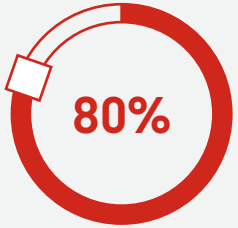
In 2019, the pharmaceutical industry put $83 billion into R&D.[5]

5. Congressional Budget Office, April 2021

COMPACT VEHICLES: STARTUPS AND SMALL-TO-MIDSIZE BUSINESSES (SMBS)

You may be surprised to learn that the federal R&D tax credit is available to **businesses of all sizes**, even startups.

If you're a small business, you can thank the **Protecting Americans from Tax Hikes** (PATH) Act of 2015, which expanded (and permanently extended) the R&D tax credit to benefit startups and SMBs. And, the **Inflation Reduction Act** (IRA) of 2022 added even more incentives for smaller companies. These laws let you apply the credit in ways that make sense for your business — and that directly affect your bottom line.



More than **80% of startups and SMBs** are not claiming their federal or state R&D tax credits.[6]

6. **Bloomberg**, April 30, 2021

Beware of speedbumps

To offset payroll, you need to show average gross receipts under $5 million for the tax year the credit is being claimed, and have no gross receipts older than five years. (For example, the R&D tax credit is not available in 2023 for companies that had gross receipts in 2018.)

To offset AMT, you need to show average annual gross receipts under $50 million for the three years preceding the current taxable year.

Offsetting payroll

The PATH Act allows small businesses to apply the R&D tax credit against their payroll tax — and the IRA doubles the amount that can be claimed. Starting in tax year 2023, qualified businesses can claim up to $2.5 million over five years ($250,000 against FICA and $250,000 against Medicaid per year). This allows smaller businesses to appreciate the benefits of the R&D tax credit even if they have little or no tax liability — thus freeing up cash flow.

Offsetting the Alternative Minimum Tax (AMT)

Under the PATH Act, as of tax year 2016, small businesses can choose to apply the R&D tax credit against the AMT — allowing them to monetize more of their R&D credits (by effectively raising the limits found in IRC Section 38).



What if I didn't claim my credits last year?

If you were eligible for the credit but didn't claim it, you may be able to file amended tax returns for the past three years. If you suffered losses, you may be able to make retroactive claims even further back.

What if I have no tax liability?

The PATH Act and the IRA provide a number of ways for small businesses to apply the credit. For example, you may be able to apply the credit against your payroll tax, allowing you to appreciate the full benefit of the credit — even if you have no liability whatsoever.

THE DESTINATION: CLAIMING THE R&D TAX CREDIT

The federal R&D tax credit, while beneficial, comes with strict eligibility and documentation requirements. So, if you're interested in claiming the credit, make sure to familiarize yourself with the various rules and guidelines — and conduct a viability study beforehand.

Conducting a study

Before claiming the credit, make sure you can identify, document and support your eligible expenses. It's worth doing because if you claim expenses or activities that aren't eligible — or that cannot be supported properly — the IRS may deny the credit and impose penalties and interest.

Filing a tax return

When filing, make sure you're familiar with the carryback and carryforward provisions. You can claim R&D tax credits with an open statute of limitations — a period that typically includes the prior three years. If your business has unused credits before that time, you may be able to apply them on future returns with a schedule of up to 20 years.

Claim the federal R&D tax credit by filing **IRS Form 6765**.



Amending a tax return

When amending tax returns, be sure you're up to date on any changes to the tax law.

The recent **IRS Chief Counsel Memorandum** requires that you submit additional information — including your company's research activities and the individuals who performed them — with each amended R&D claim.

The **Tax Cuts and Jobs Act** (TCJA) of 2017 amended IRC Section 174. You are required to capitalize and amortize all R&D expenses (over 5 years for U.S.-based activity and over 15 years outside of the U.S.), including software development costs, for tax years beginning on or after January 1, 2022. (This requirement is still in effect despite bipartisan efforts to delay or repeal it.)

The road to savings



CONDUCT A STUDY



FILE A TAX RETURN



AMEND A TAX RETURN



RECEIVE THE CREDIT



REDUCE YOUR TAX LIABILITY



What kind of documentation will I have to provide?

When filling out IRS Form 6765, you'll need to show how your expenses qualify for the R&D credit. Though no specific documentation is to be included with your return, you must conduct a study to substantiate the credit. Financial records, business records, oral testimony or technical documents can be used for this purpose.

How can a "carryforward" help me?

The carryforward allows you to apply this year's tax credits in the future. It's particularly beneficial to those who invested in R&D and didn't turn a profit, or whose credits outweigh their liabilities. (Unused credits first carryback, then carryforward up to 20 years.)

"THE ADP R&D TAX CREDIT TEAM HAS ACCESS TO ALL THE INFORMATION … THEY WERE ABLE TO LOOK BACK ON THE LAST THREE YEARS AND DETERMINE THAT WE WERE ELIGIBLE FOR TAX CREDITS TOTALING BETWEEN $70,000–$100,000."

MATTHEW GEBAROWSKI
President, DirtLogic, LLC

REV YOUR ENGINE WITH ADP

Nothing runs more efficiently than a finely tuned engine. In the world of R&D tax credits, that engine is ADP.

At ADP, our R&D experts step you through the process of claiming the credit, making sure you identify all of your qualified expenses and apply them in the best way possible. The results are impressive: **Our R&D clients have averaged a 400% to 500% return on their investments.**[7]:

We offer our clients:

- A team of experts specially trained to maximize R&D credits within IRS guidelines
- A free estimate of a company's federal and state R&D tax credits
- An examination of a company's qualified research activities and expenses
- A transparent working relationship
- A fee structure that is based on success

7. Individual results may vary

It's time to get on the road to success.
Visit adp.com/rd-taxguide today.



"TAKING ADVANTAGE OF THE ADP R&D TAX CREDIT SOLUTION HAS ALLOWED US TO REALIZE OPPORTUNITIES WE EITHER WERE UNAWARE EXISTED OR DID NOT HAVE THE RESOURCES TO EXPLORE."

DINESH PATEL,
President, US Pharmaceuticals

WHY ADP?

At ADP, we've built a global reputation on our expertise, technology and resources — and for helping clients capture more than $1.1 billion in tax credits and incentives in a single year.[8]

Plus, we integrate seamlessly with most major payroll systems, so you can benefit from our expertise regardless of the systems you have in place or the size of your business. Equally important, our relationships with federal and state agencies keep us on top of changing laws and compliance requirements.

8. ADP internal data, 2019

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Does ADP work with CPAs?

Yes. If you're an accountant, **we're ready to help** maximize your clients' R&D tax credits by sharing with you our technology and expertise, along with the latest federal and state laws and regulations. We stand behind our service: We'll support your client in the event of an audit; and we'll refund our fees if we support the audit and the R&D credit is denied due to an error on our part.

At ADP, we always respect your relationship with your client. You will always remain your client's advisor.

START YOUR JOURNEY

ADP offers a complimentary assessment to determine whether you're eligible for the R&D tax credit, and we'll estimate how much you stand to gain by claiming it. To learn more, visit **adp.com/rd-taxguide**

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