

KBKG Tax insight: Tips for Documenting Qualifying R&D Expenses

Every company seeks effective ways to reduce their overall tax liabilities. Although traditional tax planning can certainly reduce business taxes, there is often a limited impact, leaving owners and managers searching for additional savings opportunities. The good news is that the Research and Development (R&D) Tax Credit is available to qualifying companies that have or are currently engaged in qualifying R&D activity. In years past many believed the R&D credit was available only to large companies for scientific and other complicated R&D activities, but recent guidance has shown that the R&D Tax Credit can apply to a slew of industries. The credit can be used to offset tax liabilities and has shown itself to be an effective means for incentivizing companies to make investments in the United States.

In order to qualify, taxpayers must apply the qualification criteria (the 4-part test) to a business component (defined as either a product, process, software, or formula). Once qualification has been determined, it's essential to begin the documentation process to capture key information on qualifying expenses such as salaries, supplies and materials, and payments made to third parties for the performance of qualifying research. To help clients, prospects, and others effectively document expenses, KBKG has provided some tips below.

Create a Documentation Process

As is the case with most areas of tax, the burden of proof rests with the taxpayer. Establishing a documentation process is critical because it ensures the company doesn't lose out on claiming any qualifying expenses due to a lack of substantiation. Beyond this, the proper documentation makes it easier to prepare a package supporting the position taken and gives easy access to this information should the IRS request documents or other information as part of an audit. When claiming R&D credits, it is always better to be proactive with the gathering of documentation versus being reactive to IRS requests. The bottom line is that a robust documentation process ensures the company will get the maximum value possible when claiming the credit.

Documentation Tips

- **Collect and Classify Documentation** – If you believe that your company has one or more projects that qualify for the R&D tax credit, then it's essential to begin collecting all documents related to the project immediately. As mentioned previously, there is a four-part test that the IRS uses to determine if a project qualifies. Collecting documentation that speaks to these four tests is key:
 - **Technical Uncertainty** – Collect documents that describe the project and technical uncertainty involved in the activities. This can be demonstrated through time sheets, records of resources allocated to the project, project records, meeting notes, notes that describe technical issues, design materials (including the assorted options considered) and feasibility studies if performed.
 - **Process of Experimentation** – For many companies, this can be challenging to document, but it can include simulations, videos of prototypes, emails and other communications commenting on testing methods, design specifications, engineer drawings and descriptions of project failures and lessons learned throughout the process.

- **Technological in Nature** – Gather documents that describe the project’s technical nature, including the design of system architecture, source code, presentations and corresponding meeting notes, engineer drawings, computer screenshots and information on technical data.
- **Qualified Purpose** – These documents should clearly highlight how the process results in a new or improved process or component. This can include project plans, an outline of benefits, case studies, project budget, meeting notes and copies of internal presentations.
- **Remember Third-Party Agreements** – If your company is working with an outside vendor to provide research, design or other services, then it’s essential to collect copies of these contracts. It’s common for the IRS to request copies of these agreements and review them carefully to determine if the covered services qualify and are permitted to be part of the credit claim.

There are many requirements that a company must comply with to claim the R&D tax credit. Proper documentation is only one aspect of the process that companies are required to manage. That’s why it’s often beneficial to consult with an R&D credit expert to assess your situation and guide your efforts. If you have questions about the R&D tax credit or would like to determine if your programs qualify for the credit, KBKG can help.

Author: Kevin Zolriasatain