



## Section 41 Research & Experimentation Tax Credit Summary of Research Credit Criteria

“McGuire Sponsel’s approach to each prospect and engagement demonstrates our appreciation for the CPA – Client relationship.”

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1. Qualification – In order to qualify for the federal tax credit, a company’s research expenditures must pass the following four-part test:
  - a. Technological in Nature
    - i. The research must rely upon principles of hard sciences, which include biology, chemistry, engineering and physics
    - ii. Activities centered around marketing, economics, humanities, management and social sciences do not qualify
    - iii. Research must be intended to discover new information
  - b. Uncertainty
    - i. The information sought must be intended to eliminate uncertainty concerning the development or improvement of the product, process, technique or formula
    - ii. Uncertainty exists if, at the conceptual phase, information available to the taxpayer does not establish the company’s capability, method or functional design of the product or process
  - c. Process of Experimentation
    - i. Evaluation of one or more alternatives to a company’s original design objective(s)
    - ii. Involves developing one or more hypotheses, testing and analyzing the hypotheses, and refining or discarding the hypotheses as part of the development
    - iii. Term of art – “Trial and Error”
  - d. Permitted Purpose
    - i. Activities must relate to the development of a new or improved function, performance, reliability or quality of the product, process or formula
    - ii. Pursuit of government or industry certification
    - iii. Activities relating to style, taste or preference factors do not qualify
2. Quantification – Qualified Research Expenditures (“QREs”) consist of the following components:
  - a. Wages
    - i. Box 1, W-2 Wages
    - ii. Engaging in qualified research

(cont’d)



## **Section 41 Research & Experimentation Tax Credit** **Summary of Research Credit Criteria** *(cont'd)*

- iii. Direct supervision or support of qualified research
- iv. "Substantially All" Rule
  
- b. Supplies
  - i. Raw materials consumed during the process of qualified research
  - ii. Prototypes and samples (for certain cases)
  
- c. Contract Research
  - i. Outside consultants'/companies' costs incurred by the taxpayer for qualified research. Includable up to 65% of the total cost
  - ii. Taxpayer must bear the economic risk of the qualified research
  
- 3. Calculation – Depending on the company's date of formation, documentation retention policies and historical dedication to research and development, one of the following calculation methods would apply:
  - a. Standard Calculation
    - i. For companies formed prior to January 1, 1984
    - ii. 1984 – 1988 base period
  
  - b. Start-Up Method
    - i. For companies formed after December 31, 1983
    - ii. Standard IRS base percentage for first five years
  
  - c. Alternative Incremental Method
    - i. Third option of companies that cannot use Standard or Start-Up calculation options.
  
  - d. Alternative Simplified Calculation Method
    - i. Effective January 1, 2007
    - ii. Reduces dependency on base period documentation
    - iii. Utilizes previous three years' QREs to determine current year's tax credit opportunity

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