Research and Development Tax Credit

The intent of the R&D credit is to give credit to companies that do research and development of new and innovative products and processes within their organization. It is a “one time” type credit, not an “every single patient” type credit.

The following QREs are the accompanying expenses incurred as a result of taking part in any activities that meet the IRS four-part test.

These could include:

- Employee wages paid for qualified services.
- Costs of supplies associated with qualifying activities.
- Third-party contract labor hired to engage in qualifying activities.
- And many more.

The R&D Tax Credit can be especially lucrative for dentists because the majority of practitioners have transformed the provision of dental treatment primarily through the implementation or development of new technologies. It is critical to the success of a dental practice to constantly test and experiment with new technologies and streamline certain processes.

For example, a dental practice might implement an intraoral scanner into the practice thereby allowing for the creation of 3D digital scans of patients. This technological solution, in turn, enables dentists to monitor their patients' progress over time, eliminate the process of making molds, and significantly lower their redo/remake rates due to the technology being more accurate on a first-run basis. Another example is dentists who conduct their own dental crown lab work in-house. Implementation of technology such as chairside CAD scanners and CAM milling units, dentists can create a process that takes hours rather than days.

THE QUALIFIED RESEARCH ACTIVITY MUST MEET THE FOLLOWING FOUR-PART TEST FROM THE IRS:

1) **Section 174 Test (AKA: Qualified Purpose Test or Elimination of Uncertainty Test)**

Purpose of the activity for expenditures must be:

- Treated as expenses incurred by the taxpayer’s trade of business.
- Represent R&D costs in the experimental or laboratory sense.

The expenditures must be incurred for activities that would eliminate uncertainty in the development or improvement of a product or business component. For example, doctor wages earned during the time period that the doctor was working on the research activity to eliminate uncertainty. Any wages earned after uncertainty was eliminated do not qualify.

Effective 1/1/2022, R&D costs may no longer be currently deductible and must be amortized ratably over 60 months unless Congress takes action. This new rule will increase your taxes in the short term.

2) **Business Component Test:**

- To pass this test the activity must intend to apply the information being discovered to develop a new or improved business component for the taxpayer.
- A business component is any product, process, software, technique, formula, or invention that is held for sale, lease or licensed to the business or used by the taxpayer in a trade of business.
- Examples for the dental industry include new or improved dental devices or new or improved dental procedures, especially if procedures were published.

3) **Process Experimentation**

- Activities must be elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality. The test MUST do the following 6 things:
- Follow principles of engineering, physics, chemistry, biology, computer science or similar "hard sciences."
- Focus on the technological nature of the activity.
- Be for the purpose of eliminating uncertainty by evaluating alternatives through modeling, simulation, and other methods.
- Taxpayers do not need to consider more than one alternative to the problem. The process needs to be evaluative and capable of considering more than one solution.
- Experiments may be done even if there is uncertainty of the method to achieve desired results, as long as the method and design of achieving results is uncertain at the outset.
- Process is evaluated by activity and is met if at least 80% of activities relate to new or improved function, performance, reliability, or quality.

Process experimentation must be thoroughly documented. Prior to beginning the research activity, the taxpayer should document the problem/uncertainty, the desired outcome, and the preliminary alternatives that will be evaluated through experimentation.

As the research activity progresses, the different alternatives should be documented along with any revisions and the outcome of each alternative. If new alternatives are identified, then it must be documented as to the initial uncertainty of whether this alternative will succeed.

Document when the activity is complete, and uncertainty has been eliminated. The expenses incurred during this process such as wages and supplies should be documented contemporaneously while performing the research. Payroll reports are not enough. There needs to be documentation as to the hours and days that are spent on the project.

4) **Technological in Nature**

- The activity must be completed by relying on hard sciences, such as engineering, computer science, or biological sciences. For this test it is NOT required that:
- The activity be successful.
- The taxpayer obtains information that exceeds common knowledge of skilled professionals in that field. In other words, the taxpayer does not need to expand their field of knowledge to complete the activity.

Two of the specific activities that are excluded from the R&D credit per the IRS are:

1) Research that adapts existing business components as if the taxpayer's activity is only to customize a product based on a customer's requirement or need.
    - For example, orthodontists that have in place Bracket Braces and Invisalign in their practice, they are not doing new R&D every time a patient comes in for braces. Rather, they are adapting an existing business component to a customer's need.
    - While some vendors may argue the "exclusion for adaptation," qualifies this experimentation, especially for orthodontic treatments, our CPAs disagree.
2) Research that duplicates existing components.

For general dentists, routine dental cleanings, fillings and extractions, and activities they perform daily don't qualify for the R&D Credit as they do not satisfy the "Section 174 test" and "process of experimentation" tests.

WHAT TRIGGERS AN R&D TAX CREDIT AUDIT?

The IRS regularly audits businesses claiming R&D tax credits. The purpose of the audits is to verify that the claims are accurate and compliant with tax laws. There are several key reasons an R&D credit claim may get flagged for audit:

Inconsistent Claims

One trigger is inconsistencies within the tax credit claim itself. For example, if the expenses outlined don't match up with the documentation provided, it raises suspicions. Also, unexplained spikes in the credit amounts claimed versus prior years may also lead to an audit.

Large, Frequent Claims

Businesses that routinely claim exceptionally large R&D tax credits are more likely to be audited. The IRS understands that substantial amounts of R&D spending occur in some industries, but they will want to ensure the size and frequency of the claims align with the company's activities.

Random Selection

In some instances, an audit is simply the result of random selection by the IRS. They use statistical formulas to determine a group of returns for review and a business may end up being chosen at random, regardless of if there are other red flags. So, audits can happen due to randomized selection.

Industry Profile

The nature of the business itself can play a role in audit likelihood. Industries like pharmaceuticals, software and manufacturing that rely heavily on R&D spending tend to see more IRS audits. The complex technical activities make it more difficult for the IRS to evaluate the legitimacy of the tax credit claims.

Economic Influences

During times of economic uncertainty and tightened government budgets, the IRS may increase tax credit audits across the board. When every dollar counts, they want to ensure all credits and deductions claimed by businesses are truly justified.

HOW TO BE PREPARED FOR A POTENTIAL R&D TAX CREDIT AUDIT:

Preparation is your best defense if the IRS requests an audit due to your R&D tax credit claim. Here are some key steps to get audit-ready:

Organize Airtight Documentation

- Pull together comprehensive records that leave no question about your R&D activities and expenses. This includes:
  - Project plans outlining the objectives, methods and desired outcomes.
  - Time logs tracking hours each employee spent on R&D work.
    - Invoices, receipts, and other proof of R&D-related costs

Work With a Specialized Tax Advisor

Hire an expert that is well-versed in R&D tax credits. They can help identify any gaps in your documentation and ensure you have responses ready for any IRS questions. Their guidance is invaluable.

Brush Up on Current R&D Tax Credit Regulations

Understand exactly what the IRS looks for in an accurate and compliant claim. Know the regulations inside and out to demonstrate the validity of your activities.

Prepare a Coherent Narrative

The IRS will want to understand the complete story behind your R&D work. Construct a narrative that logically ties together your documentation and brings your projects to life to clearly define your R&D claim with no gray areas.

Anticipate Follow-Up Requests

Audits often involve multiple information requests/exchanges. Develop processes to quickly retrieve additional materials needed. Respond promptly at each stage.

Consider Legal Counsel

If your claim is exceptionally complex, legal guidance may be advisable to protect your interests and assist in guidance.

R&D Tax Credit under PATH Act of 2015

- The R&D credit was permanently extended as part of the (PATH) Act of 2015.
- The bill included enhancements starting in 2016, that included offsets to the alternative minimum tax and payroll tax for eligible businesses.
- The credit is used to offset payroll taxes but is based on eligible R&D expenses, it only applies to costs incurred after the bill was signed into law.
- The maximum benefit an eligible company can claim against payroll taxes each year under the PATH Act is $250,000 annually until December 31, 2022,
- After December 31, 2022, the Inflation Reduction Act increased the election to $500,000.
- R&D tax credit is a dollar-for-dollar tax savings that directly reduces a company’s tax liability.
- If the federal R&D credit can’t be used immediately or completely, then any unused credit can be carried back one year or carried forward for up to 20 years. Each state has its own carryover rules.
- Companies that haven’t previously taken advantage of the tax credit have the option to look back at all open tax years, typically three to four years depending on when tax returns were filed, to claim the missed opportunity.

Sources

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