

## Credit for Research and Development Activities

### **SECTION 41 (R&D Tax Credit)**

**Tax treatment.** Reduces federal tax liability dollar-for-dollar; credit amount is grossed up (i.e., addback to taxable income). The [two methodologies](#) for calculating R&D tax credit are the:

- regular research credit calculation (RRC) method; or
- alternative simplified credit (ASC) method.

**Section 41 requirements.** The taxpayer must be/have:

1. engaged in qualified R&D activities (must meet [4-part test](#));
2. incurred expenses for qualifying R&D activities;
3. performed R&D activities within the U.S.; and
4. solid support (e.g., documentation) of R&D activities.

**Qualifying expenses:** Much narrower scope than §174 and §174A:

- Wages paid to employees for qualified research services
- Supplies purchased for use in qualified research
- Outside contract research (only 65% is a qualified expense)
- Leased off-premises computer costs
- Qualified software development (excluding internal use and foreign software)

**Non-qualifying expenses:**

- Cost of depreciable tangible assets used in qualified research
- Overhead expenses
- Fringe benefits for research personnel

**Additional considerations:**

- There is no limitation on credit computation. However, the §41 credit is subject to:
  - the [general business credits limitation](#); and
  - a \$500,000 maximum for qualified small businesses for tax years beginning after December 31, 2022 [[§41\(h\)\(4\)\(B\)](#)].
- [Section 280C\(c\) elections](#)

## Deduction for Research and Experimental Expenses

### **SECTION 174A (Immediate Deduction of Domestic R&E Expenses)**

**Tax treatment.** For tax years beginning on or after January 1, 2025 (or after 2022 for qualified small businesses), taxpayers may immediately deduct domestic R&E expenditures that are paid or incurred by the taxpayer during the taxable year. [Transition rules apply](#).

**Section 174A test.** The expenditure must:

1. be incurred in connection with taxpayer's trade or business; and
2. represent a domestic R&D cost in the experimental or laboratory sense.

### **SECTION 174 (Amortization of Foreign R&E Expenses)**

**Tax treatment.** For tax years beginning on or after January 1, 2022, taxpayers must:

1. capitalize foreign R&E expenditures that are paid or incurred by the taxpayer during the taxable year; and
2. amortize over a 15-year period, beginning with the midpoint of the taxable year in which the expenses are paid or incurred.
  - (i.e., 2022 deduction = (R&E expenditures ÷ 15 years) × ½ year)

**Qualifying expenses (§174 and §174A):** Much broader scope than §41:

- Internal-use software development
- Patent fees and patent-related costs
- Abandoned, retired, or disposed of R&D projects
- Utilities (e.g., heat, light, power)
- Administrative and overhead
- Drawings and models
- Laboratory materials
- Depreciation on real property attributable to R&D project
- All other qualifying expenses under §41

**Non-qualifying expenses (§174 and §174A):**

- Consumer surveys
- Management studies
- Advertising expenses
- Quality control testing

## R&D Tax Credit: Qualifiers

### 4-Part Test for Qualifying R&D Activities [[§41\(d\)\(1\)](#)]:

**Section 174A** Expenditures connected with the research activities must be eligible for treatment as expenses under §174A

**Technological Information** Research must be undertaken for the purpose of discovering information that is technological in nature  
Application of such research is intended to be useful in the development of a new or improved business component of the taxpayer

**Process of Experimentation** Must constitute elements of a process of experimentation for a purpose relating to a new or improved function, performance, reliability, or quality  
Process of experimentation must be an evaluative process and generally should be capable of evaluating more than one alternative

**Business Component** Information to be discovered is intended to be useful in the development of a new or improved business component (i.e., product, process, computer software, technique, formula, or invention held for sale/lease or used in the taxpayer's trade or business)

### General Business Credit Limitation [[§38\(c\)](#)]:

C-corporations with more than \$25,000 in regular tax liability cannot offset more than 75% of their tax liability with general business credits (which includes the R&D tax credit).

If the §41 credit exceeds the general business credit limitation, then unused credits are subject to a 1-year carryback and 20-year carryforward period for the remaining amount.

### Qualified Small Business Test [[§41\(h\)\(3\)](#)]:

A taxpayer is generally a qualified small business if:

1. its gross receipts for the tax year are less than \$5 million; AND
2. it didn't have gross receipts over \$5 million for any of the past five tax years.

## R&D Tax Credit: Calculation

### Regular Research Credit (RRC) Method [[§41\(c\)](#)]:

1. Fixed-base percentage = aggregate qualified research expenses (QREs) for tax years beginning after December 31, 1983, and before January 1, 1989, and divide by aggregate gross receipts for the same period. *Percentage cannot exceed 16%.*  
\*Taxpayers not in existence before 1989, see [§41\(c\)\(3\)\(B\)](#).
2. Base amount = fixed-base percentage multiplied by taxpayer's average annual gross receipts for the four tax years preceding the relevant tax year. *Amount cannot be less than 50% of the QREs for the relevant tax year.*
3. Credit = 20% of the company's current year QREs, less the base amount.

### Alternative Simplified Credit (ASC) Method [[§41\(c\)\(4\)](#)]:

\*This method must be elected by the taxpayer.

1. Determine the average QREs for the 3-year period directly preceding the current tax year.
2. Take the 3-year average from step one and multiply by 50%.
3. Determine the current year QREs.
4. Excess = subtract step 2 from current year QREs.
5. Credit = excess from step 4 multiplied by 14%.

Year	QREs	Gross Receipts
1984	\$50,000	\$150,000
1985	\$75,000	\$230,000
1986	\$60,000	\$215,000
1987	\$80,000	\$250,000
1988	\$20,000	\$200,000

Year	QREs	Gross Receipts
2019	\$50,000	\$560,000
2020	\$90,000	\$640,000
2021	\$80,000	\$800,000
2022	\$80,000	\$720,000
2023	\$120,000	\$600,000

### RRC Method:

1. Fixed-base percentage:  $(50,000 + 75,000 + 60,000 + 80,000 + 20,000) \div (\$150,000 + 230,000 + 215,000 + 250,000 + 200,000) = 27\%$ . *Because this is over the cap of 16%, the fixed base percentage is limited to 16%.*
2. Base amount:  $(560,000 + 640,000 + 800,000 + 720,000) \div 4 = \$680,000 \times 0.16 = \$108,800$ . *50% of the QREs for the credit year (2023) is \$60,000, so the base amount is limited to \$60,000.*
3. Credit:  $(\$120,000 - \$60,000) \times 0.2 = \$12,000$

### ASC Method:

1. 3-year average QREs:  $(90,000 + 80,000 + 80,000) \div 3 = \$83,334$
2. 50% of step 1:  $\$83,334 \times 0.5 = \$41,667$
3. Current year QREs: for 2023 = \$120,000
4. Excess:  $\$120,000 - \$41,667 = \$78,333$
5. Credit:  $\$78,333 \times 0.14 = \$10,967$

## R&E Tax Deduction: Legislative Changes

Tax Year	Domestic R&E	Foreign R&E
Before 2022	Deduct or amortize	Deduct or amortize
2022 - 2024	5-year amortization	15-year amortization
2025 and after	Immediate deduction (or elective amortization); transition rules apply	15-year amortization

### Transition Rules:

Taxpayers can deduct any remaining unamortized domestic R&E entirely in 2025, or over a two-year period (2025 and 2026).

If the taxpayer is a qualified small business, it may elect to apply §174A retroactively by amending its 2022 through 2024 returns to deduct R&E costs immediately.

### Qualified Small Business Test:

A taxpayer is generally a qualified small business if:

1. under the gross receipts test of §448(c)(3), the taxpayer has average annual gross receipts for the three prior taxable years that do not exceed a threshold amount; AND
2. the first tax year begins after December 31, 2024.

### Elective Amortization:

Taxpayers may elect to amortize domestic R&E not chargeable to property subject to depreciation or depletion. Under the election, the taxpayer:

- charges the R&E to capital account; AND
- may amortize the deduction ratably over a period of at least five years, beginning with the month the benefit is realized.

### Election Statement Requirements:

For the first year a taxpayer elects the method under §174A, a statement must be attached to their original federal income tax return and include the following:

1. "Filed pursuant to §6.02 of Rev. Proc. 2025-28" marked at the top;
2. name and TIN number;
3. the taxable year in which the election is made;
4. a declaration that the applicant is charging such expenditures to an R&E capital account, and amortizing over at least five years, beginning with the month in which benefit from such expenditures is first realized; and
5. the number of months selected (at least 60 months) for the amortization period.

## Section 280C Election and Form 6765

Section 280C(c)(1) requires that any deduction under §174A be reduced by any R&D credit taken under §41(a), unless the taxpayer elects to reduce the R&D credit. Under §280C(c)(2), if the taxpayer capitalizes rather than deducts research expenditures, and the R&D tax credit determined for the taxable year under §41(a)(1) exceeds the amount allowable as a deduction for the taxable year for qualified research expenses or basic research expenses, the amount chargeable to capital account for the taxable year for such expenses shall be reduced by the excess. In other words, the excess of the R&D tax credit over the allowable deduction needs to be added back to taxable income.

If a §280C(c)(2) election is made, the research credit is reduced by an amount equal to the credit multiplied by the highest corporate tax rate in lieu of adding back the excess amount from §280C(c)(1).

To make a §280C election, taxpayers must file Form 6765, *Credit for Increasing Research Activities*.

In tax year 2026, a C corporation has taxable income of \$5 million, which includes \$750,000 of domestic qualified research expenses. The R&D credit available is \$800,000. The corporate income tax rate is 21%.

### Without §280C(c)(2) Election:

Taxable income	\$5,000,000
Addback <b>excess</b> R&D credit (\$800,000 - \$750,000)	\$50,000
Subtotal	\$5,050,000
Tax liability (21%)	\$1,060,500
Gross R&D credit	(\$800,000)
Final tax liability	\$260,500

### With §280C(c)(2) Election:

Taxable income	\$5,000,000
Tax liability (21%)	\$1,050,000
Tax-effected R&D credit (\$800,000 × 0.79)	(\$632,000)
Final tax liability	\$418,000