Federal and certain states’ tax laws permit a research and development (R&D) tax credit to the extent that a taxpayer’s current-year qualified research expenses exceed a calculated base amount of research spending. The federal and state credit benefits are generally greater than 10 percent of qualified spending for the year.

**Business-component test**

The goal of the activity must be to develop a new or improved business component, which includes:

1. Product
2. Process
3. Computer software
4. Formula
5. Technique
6. Invention
7. A subcomponent of any of these “business components.”

**Qualified research expenditures**

The following expenditures can be included:

1. Wages (taxable) of employees performing, or directly supervising, or directly supporting research
2. Supplies (materials) used in the conduct of research
3. Contract research – payments for the conduct of research (generally 65 percent of cost is qualified)
4. Rental or lease costs of computers - payments for use of computers, including cloud resources, in the conduct of research so long as the computer(s) is located off the taxpayer’s premises and the taxpayer is not the primary user of the computer(s)

**Qualifying research activities**

Wages for an employee qualify for the credit if the employee performs the following services related to qualified research:

1. Actual “hands-on” conducting of research – software design, engineering, prototyping, testing
2. Direct supervision of research – first-line supervision
3. Direct support of research – defines functional specifications, provides direct administrative support

**General four-part activity test**

To qualify, a business component must be (all of these criteria must be met):

1. Conducted for a permitted purpose – the intention of a new or improved level of:
   a. Function
   b. Performance
   c. Reliability
   d. Quality.
2. Technological in nature – the activity must fundamentally rely on principles of:
   a. Physical or biological sciences
   b. Engineering
   c. Computer science.
3. Intended to eliminate uncertainty (any one or more of the following uncertainties qualifies):
   a. Capability uncertainty – Can we do it?
   b. Methodology uncertainty – How can we do it?
   c. Design uncertainty – What is the best way to do it?
4. Substantially all of the activities involve elements of a process of experimentation – “experimentation” includes:
   a. Identifying and evaluating one or more alternatives
   b. Testing to attempt to resolve uncertainties such as performing modeling, simulation, or a systematic trial and error methodology.
High threshold of innovation test required for internal-use software (IUS) development

1. The software must be innovative.
2. The software development must involve significant economic risk.
3. The software is not commercially available.

IUS

Software developed for use in general and administrative (G&A) functions that facilitate or support the taxpayer’s trade or business.

Non-IUS

If the software is intended to do one of the following, then the activity is subject to the four-part test only:
1. Software is developed with the intent to be commercially sold, leased, licensed, or otherwise marketed to third parties.
2. Software is developed solely with the intent to enable a taxpayer to interact with third parties or allow third parties to initiate functions or review data.
3. Software is not developed to be used in a taxpayer’s G&A function.
4. Software is developed for use in an activity that constitutes qualified research (other than the development of the IUS itself).
5. Software is developed as part of a production process that meets the four-part test.
6. Software and hardware are developed as a single product.

Dual function software

Software developed both for taxpayer’s G&A functions and to enable interaction with third parties:
1. Dual function software that is developed to be used in taxpayer’s G&A function and to allow third-party interaction will generally be subject to the seven-part test.
2. Identifiable subset of the dual function software that provides only third-party interaction will be subject only to the four-part test.
3. Safe harbor for dual function software or dual function subset of dual function software where third-party interaction cannot be segregated from the G&A functions: taxpayers may include 25 percent of qualified expenditures, provided the use of the third-party interaction is reasonably anticipated to constitute at least 10 percent of the dual function software or dual function subset’s total use and the dual function or the subset meets the four-part test.

Other considerations

Qualifying activities and expenditures may exist outside the R&D departments, including operations and production functions, customer support (testing), marketing (functional specifications and product management), and information technology.

The R&D credit is claimed by most industries. If your company is investing in improving the business, the R&D credit should be considered.

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1 The additional three-part test for IUS is based upon the final IUS regulations published in the Federal Register on October 4, 2016.