TECH SAVVY TAX STRATEGIES

Navigating the Potential R&D Tax Law Changes for Software Companies

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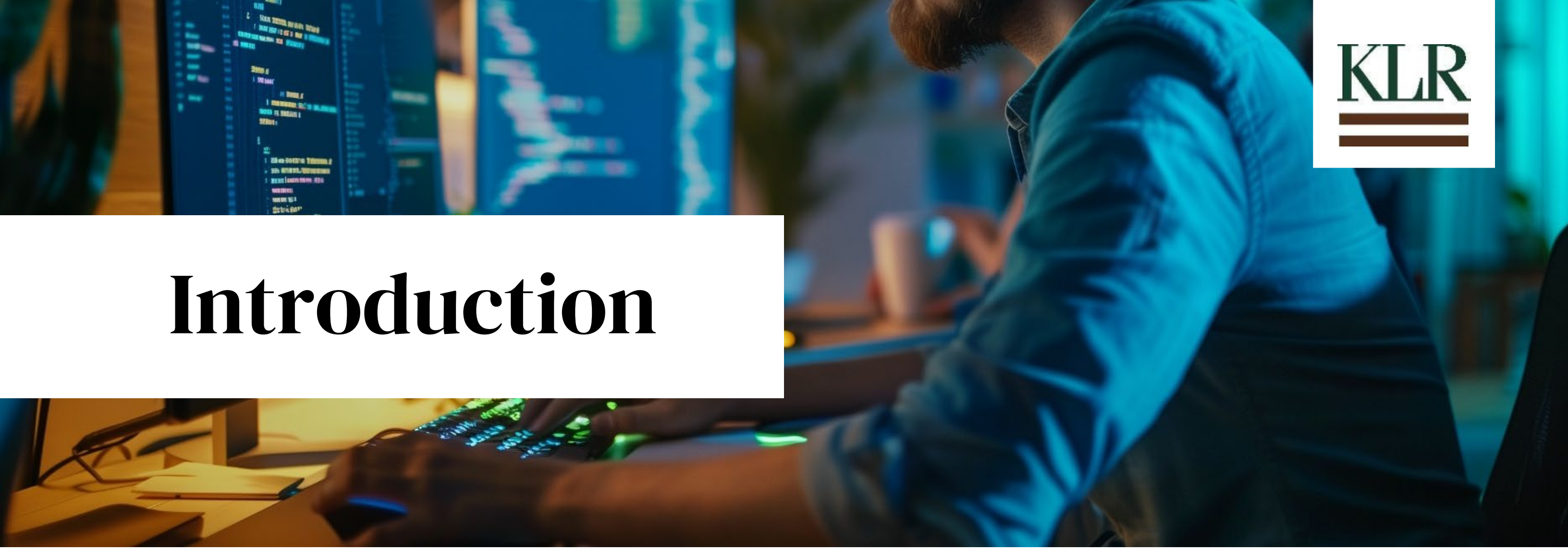
As companies continue to push the boundaries of innovation, significant tax law changes in 2025 are predicted to reshape the landscape of research and development (R&D) tax credits. These updates could present both challenges and opportunities for software companies and businesses across various industries.

This white paper provides a comprehensive overview of

- Proposed 2025 changes to R&D tax laws,
- Insights into how they will impact your business, and
- Actionable strategies to maximize your tax savings.

Whether you're a startup, an established corporation, or a software innovator in a high-tech industry, understanding these changes will help you stay ahead and capitalize on available incentives.



Introduction

Introduction to R&D Tax Credits

R&D tax credits are a valuable financial incentive designed to reward businesses that engage in research and development activities. These credits provide a dollar-for-dollar reduction in tax liability, helping companies offset the costs of innovation. Whether you're improving products, developing new technologies, or optimizing processes, the R&D tax credit can deliver significant financial savings.

With the recent changes in U.S. tax law, the R&D tax credit landscape has evolved. As we move into 2025, businesses need to stay informed about the new rules to fully leverage these incentives.

FAQ: Why Do I Need an R&D Study?

A R&D study helps ensure that your company is claiming all eligible R&D tax credits it's entitled to, **potentially leading to significant tax savings**. Allocating costs to R&D is a skill and we can help train your team to develop these techniques. The potential tax savings and benefits typically outweigh the costs in the long run.

Key Changes for 2025

Here’s what’s Most Likely to Change this year:

A. Potential Repeal of Section 174 Capitalization

Previously, companies could immediately deduct their R&D expenses. However, since 2022, the Tax Cuts and Jobs Act (TCJA) has required businesses to capitalize and amortize R&D expenses over five years for domestic research or 15 years for foreign research.

2025 Update: There is strong advocacy to repeal or delay this provision, allowing businesses to return to the previous system of immediate deductions. If this happens, companies will experience significant cash flow improvements by deducting R&D expenses in the year they are incurred.

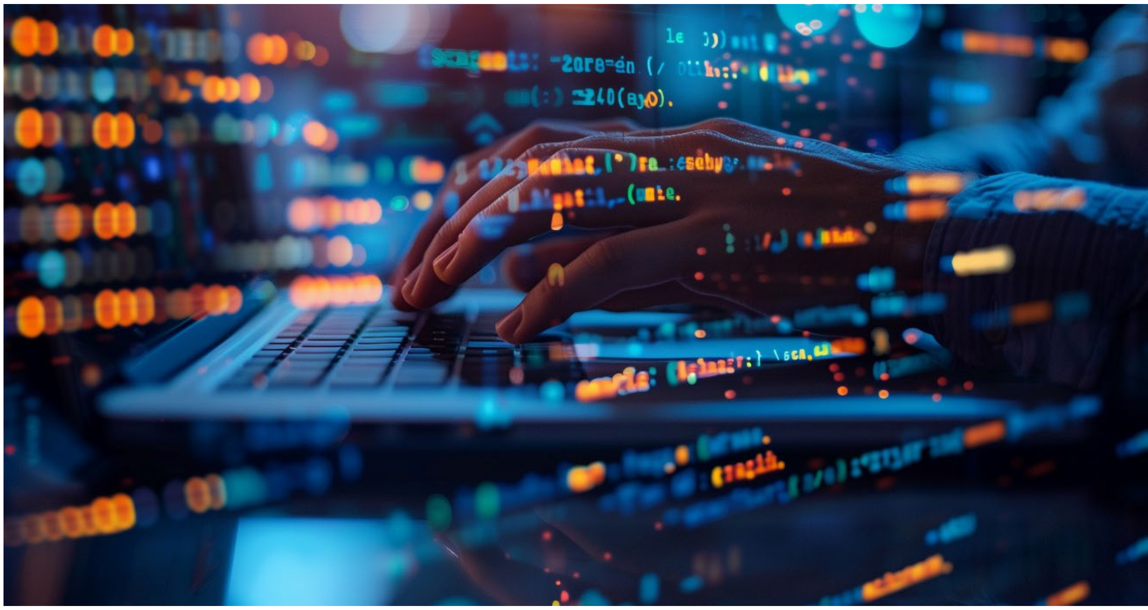
B. Proposed Tax Form Changes

In an effort to ensure better compliance with this tax credit, the IRS has proposed changes beginning for the 2024 tax year to the Form 6765 which is used to claim the credit on business tax returns. Currently, the Form only requires companies to list their qualified research expenses and some historic data. The proposed changes would require much more detailed reporting on business components developed, qualified research activities, and reasons why the business is entitled to the credit.

While some of the reporting may be optional in certain instances, complying with these form changes will require expertise in the tax code and case law surrounding R&D credits.

C. Expanded Payroll Tax Offset for Startups

The Inflation Reduction Act increased the payroll tax offset for small businesses and startups from $250,000 to $500,000, effective in 2023. This expanded benefit allows startups that don’t yet have income tax liabilities to use the R&D credit to offset payroll taxes.



D. IRS Guidance on Software Development

Many businesses struggle to determine whether their software development activities qualify for the R&D tax credit, especially when it comes to **internal-use software**. In 2025, the IRS is expected to provide more clarity, potentially expanding the eligibility for software development activities to qualify for R&D credits.

Industries Most Impacted

Certain industries are particularly well-positioned to benefit from the upcoming changes to R&D tax laws. These include:

- **Technology and Software Development**: With IRS guidance expected on internal-use software, more tech companies may qualify for the R&D credit.
- **Pharmaceuticals and Biotech**: These industries invest heavily in R&D, and the potential repeal of Section 174 will significantly impact their cash flow.
- **Manufacturing**: From process improvement to product design, manufacturers engaged in innovation can maximize their tax savings under these new provisions.
- **Automotive and Cleantech**: With the shift towards electric vehicles and renewable energy, companies in these sectors stand to benefit from R&D tax credits.

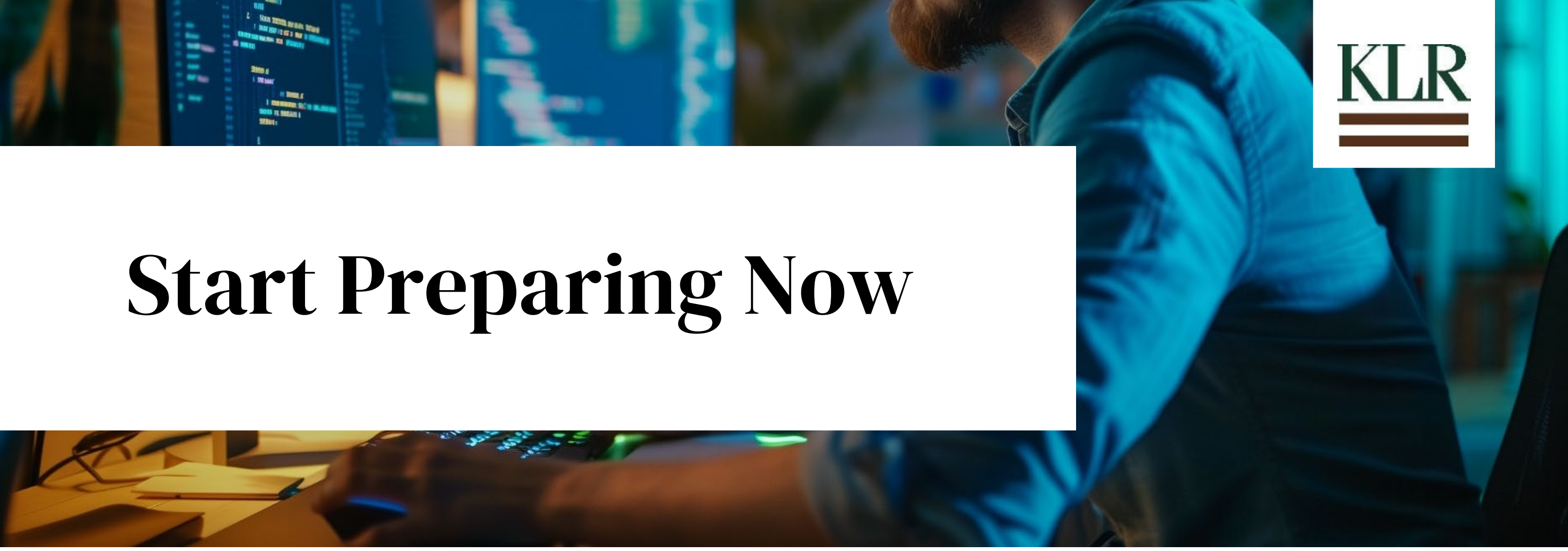
These industries, along with others like aerospace, healthcare, and telecommunications, should stay particularly attuned to the upcoming changes.

How to Qualify for R&D Tax Credits

To qualify for the R&D tax credit, your business must meet the four-part test:

1. **Permitted purpose (business component test):** The business must show that their activities seek to develop or improve a product, technique, formula, or computer software that is held for sale or used in the trade or business of the company.
2. **Uncertainty Test:** Companies must show that their activities on a project intended to eliminate uncertainty. Uncertainty means lack of knowledge on the appropriate designs, techniques, or formulas needed to achieve a desired outcome.
3. **Process of Experimentation Test:** Companies must show that they utilized activities that involved a process of experimentation (POE) on the project. A POE is any process intended to eliminate uncertainty by evaluating alternatives through modeling, simulation, or systematic trial and error.
4. **Technical in Nature Test:** All activities must rely on the principles of science, engineering, mathematics, or some technical discipline.

Additionally, companies must identify **Qualified Research Expenses (QREs)**, which include wages for employees engaged in R&D, supplies used in research, and 65% of contract research expenses.



Start Preparing Now

Software companies are one of the most innovative sectors in business today. Here are some strategies to help your business maximize its R&D tax savings:

- **Plan Ahead for Section 174 Repeal**: If Section 174 is repealed, ensure that you're ready to take advantage of immediate deductions of R&D expenses. Review your general ledger detail and talking with internal and/or external experts to ensure proper classification of costs.
- **Track All Qualifying Activities**: Accurately document all R&D activities to ensure you're capturing all eligible expenses. This will include payroll records and invoices, but also may include contemporaneous documentation such as hour logs, emails, design documents, prototype videos, etc.
- **Utilize Payroll Tax Offsets**: Startups and small businesses in the first five years of operations with less than $5 million in gross receipts can use the expanded R&D tax credit to offset up to $500,000 in payroll taxes.
- **Claim State-Level Credits**: Many states offer R&D tax credits in addition to the federal credit, providing even more opportunities for tax savings.

State-Level Incentives

In addition to the federal R&D tax credit, many states provide their own R&D incentives that closely parallel the federal research credit. Some states offer refundable credits, meaning that businesses can receive a cash benefit even if they don’t owe tax.

Others allow credits to be carried forward for future use or transferred to other businesses. For example:

Rhode Island - RI allows a C Corporation entity an average credit of 11% of incremental QREs, with any unused amounts carried forward 7 years.

Massachusetts - MA allows C and S Corporations, as well as unincorporated flow-throughs, to benefit from the credit, offsetting up to 10% of incremental QREs on either entity income tax or the tangibles and net worth tax. Unused credits can be carried forward generally for 15 years.

Connecticut - CT allows a tax credit of 20% incremental QREs against the tax imposed under Chapter 208 (Corporation Business Tax) for research and development expenses. Unused tax credits may be carried forward for 15 years. CT also allows a taxpayer who meets certain criteria to exchange unused credits for a reduced credit refund.

Check your state’s specific guidelines to ensure you are fully taking advantage of these local benefits.

Next Steps for 2025 and Beyond

To fully capitalize on the changes to R&D tax law, businesses should:

- Review current R&D activities and ensure they meet the 4-part test qualifications. Determine what constitutes research versus routine process improvement or product support. Track all qualifying expenses and supporting documentation in real-time.
- Prepare for potential changes to Section 174 by monitoring legislative developments.
- Explore state-level R&D incentives for additional savings.
- Consider an R&D study performed by an outside expert to ensure all qualified expenses are being captured.

Unlocking Innovation with Tax Savings

The changes to R&D tax laws in 2025 present a significant opportunity for businesses to reduce their tax burden while continuing to invest in innovation. **Just $200,000 in qualified expenses can result in an average of $20,000 dollars in federal tax savings for your company (without taking into consideration state eligibility).**

By staying informed, documenting eligible activities, and planning ahead, your business can maximize its R&D tax savings and fuel future growth.

Your Questions. Answered.

FAQ:

My general ledger tracks all the expenses, so doesn’t that support the claim?

The IRS requires companies to maintain a sufficient amount of documentation explaining why they are entitled to the credit. A R&D Study will provide an IRS-approved calculation methodology as well as the legal analysis and workpapers needed to explain why your business is entitled to the credit.

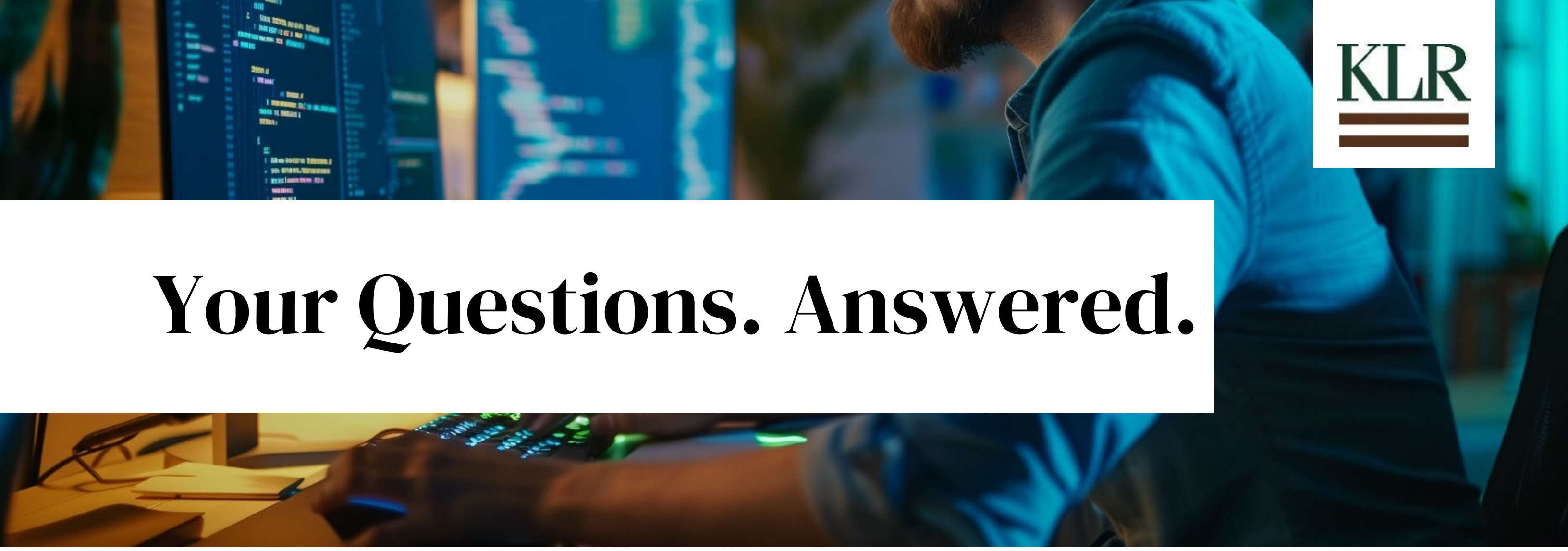
Attempting to complete the new Form 6765 without an R&D study could be very difficult and result in the Form being rejected.

FAQ:

Can’t I just calculate the expenses on my own and provide them to my CPA?

The definition of R&D expense under the tax code is different than the way many businesses understand and define R&D. It is our experience that in most cases, businesses that do the calculations themselves either:

a. Include expenses that conflict with regulations and case law
b. Undercount the number of projects and employees that meet the definition of R&D



Your Questions. Answered.

FAQ:

Why should I do this now?

The landscape of how R&D expenses are defined and treated has changed dramatically over the past 3 years. The credit has become increasingly popular and more valuable. At the same time a bevy of new tax court cases as well as the Section 174 amortization make it imperative for businesses to reexamine their R&D Tax Strategy.

FAQ:

I did an R&D study years ago, Shouldn't that be fine?

The IRS and the tax courts have established they expect much more detail in order for businesses to comply with the tax law over the past three years. Calculation methodologies and legal analyses need to be refreshed to keep up with the most recent precedent.

FAQ:

What distinguishes a KLR study from other providers?

The IRS refocused its efforts on examining research tax credits after it concluded that formal tax credit claims were being filed using high-level estimates and invalid assumptions, without a connection to the required 4-part requirements, and without documentation to support the claims. This is often referred to as a "canned report."

KLR takes a much different approach, studying not only IRS guidance but also tax credit case law to ensure that our studies will meet established standards and the latest court rulings. Our ultimate goal is <u>real</u> tax savings for our clients.

Are You Ready to Maximize Your Tax Savings with R&D Credits?

Schedule a 15-minute discovery call to learn more about how the expected changes will affect your business and how we can help maximize your tax savings with R&D credits.

Let’s make sure we’re the right fit.

Schedule a Call

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About the Author: Deb is a Partner within KLR’s Tax Services Group and directs the Research and Development department. She has over 25 years of experience helping businesses leverage innovation to fuel growth. A CPA with broad tax expertise, Deb goes beyond R&D tax credits to assist medium-sized, privately held businesses across industries like manufacturing, technology, and life sciences. Her tailored strategies and passion for maximizing tax savings empower companies to achieve their full potential.

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