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**Re: The R&D Tax Credit and
Artificial Intelligence (AI)**

Dear Clients, Colleagues, and Friends:

This Newsletter (NL) explains the basics of the Research and Development (R&D) tax credit.[1] It was developed differently than our previous NLs. We used Artificial Intelligence (AI) to create parts of it. This introduction has comments regarding our AI experience, and then the NL presents the substantive aspects of the credit. Our five AI comments are: (a) AI efficiently created a working draft but the draft was wordy seemingly *afraid* to take a position; (b) we deleted and adjusted AI's *tread water* text; (c) we then verified if the adjusted draft was consistent with the tax statutes and regulations; (d) we then added our ***Tax Tips!***; and (e) finished it by testing what we learned with actual calculations using our tax preparation software. Overall, AI did a nice job with its full sentence searches that assisted us with text and ideas [2] to better explain the credit.

The R&D Tax Credits: What Businesses Need to Know

A.   Eligible Activities. Businesses conducting innovative and/or experimental enterprises may be eligible to claim tax credits for certain expenditures. The IRS promulgates a four step process identifying activities that are R&D for tax purposes. They are:

1.   Development of New or Improved Business Components. This could include a new or improved product, process, formula, technique, or software. The component must: (1) be intended for business use, *and* (2) be something that hasn't been readily available before.

2.   Technological in Nature. Your activity must be based in the physical or biological sciences, engineering, or computer science. It could also include activities related to the development of software, but only if the software is intended to be used in a way that requires significant technical expertise.

3.   Elimination of Uncertainty. There must be some uncertainty as to the capability, method, or design of the business component being developed. The R&D activity must be undertaken to resolve this uncertainty, through the development of new information or the discovery of new principles.

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[1] The R&D tax credit is similar to an actual tax payment, plus the underlying expense is tax deductible. *See* I.R.C. §174 and Treas. Regs. §1.174 *et. seq.*

[2] Some commentators make the case AI merely copies others' intellectual work, resulting in a legal method by which Big Tech avoids paying royalties to third parties.

4.   **Process of Experimentation.** The activity must involve a systematic process of testing and analysis to evaluate one or more alternatives to achieve a result. The experimentation must be based on established principles of science and engineering and must be undertaken with the intent of discovering information to eliminate uncertainty.

B.   Qualified Research Expenses (QREs). After determining if the credit applies the next step is identify and calculate the expenses directly related to R&D activities, which may include wages, supplies, contract research expenses and others. But, capital expenditures are not eligible for QRE[3].   The next section is a "working example" demonstrating the value of the credit.

C.   Credit Working Example (See Exhibit #1, Page 3). Assume Innovation, Inc. is a corporation that grosses $1,000,000 a year, incurs $900,000 of expenses, and thus generates an operating profit of $100,000. Further suppose 2023 is its first year for R&D activities, and $25,000 of its payroll is QRE plus $100,000 of its Service and Product Costs, such as Supplies, are QRE. **Exhibit #1** has two P&Ls. One calculating the tax without the credit, resulting in a $21,000 owed, and the other P&L with the credit. The R&D credit results in lowering the tax to $8,500 ($21,000 tax less the $12,500 credit). Thus, net income increases from $79,000 to $91,500 or about a 16% increase.

The Finer Points of the R&D Tax Credit

D.   Credit Percentage. The credit is 50% of QREs that is in *excess* of a base amount. The excess is then multiplied by a certain percentage (about 5% to 10%) [4] to arrive at the R&D tax credit amount. Because the credit's objective is to incentivize *increasing* R&D, historical QRE is subtracted, then that product is multiplied by the credit percentage. ***Tax Tip!*** Calculate your taxes using the different R&D credit methods and elections. Then select the one that yields the better tax result while considering how your initial determination may affect future years.

E.   Documentation. Retain thorough documentation of your R&D activities, including records of expenditures, employee time spent on the activities, and a detailed description of the activities themselves. Some costs can be difficult to determine if they qualify for QRE. ***Tax Tip!*** In those cases, document what is your reasoning process for how you applied the rules in Section A. Documentation can include a writing of the decision making steps on how the "close calls" were determined, and then apply that methodology consistently year after year.

F.   Carryforward. Any unused R&D tax credits can be carried forward for up to 20 years, and in some cases, can be carried back to previous years.

In conclusion, if after reading our NL, you believe your business may qualify for the R&D tax credit, please contact us at 918-901-9000 or TheOffice@paulhburgess.com. Additionally, with this NL our firm started learning how to use and refine AI's full sentence inquires. We liked it, especially the nice job it did synthesizing the IRS's four-part test in Section A. As such, we will continue exploring AI's capabilities to assist us in yielding a better result for our clients.

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[3] *See* I.R.C. §174 (a)(1) and (2).

[4] The certain percentage can be determined under two methods with each method having certain elections.

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The Research and Development Credit Innovation, Inc. Income Statement (P&L) for 2023	P&L Without R&D Credit	P&L With R&D Credit	Credit Calcs. & Tax Savings
Gross Revenues	$ 1,000,000	$ 1,000,000	
Less: Expenses			
Employee Payroll	(250,000)	(225,000)	
Qualified R&D Wages (or QRE wages)	-	(25,000)	25,000
Service and Product (S&P) Costs	(500,000)	(400,000)	
QRE Portion of S&P Costs	-	(100,000)	100,000
Administration (Admin is typically not QRE)	(150,000)	(150,000)	
Equals: Taxable Income	**100,000**	**100,000**	
Calculation of R&D Credit:			
Total QRE from above			125,000
Less: Historical QRE (None - Innovation's 1st Year)			-
Subtract 50% of the QRE			(62,500)
Sub-Total to Apply the Elected Method Percentage			62,500
Multiple by 20% (Using one of two methods)			20%
Equals: the R&D Credit Amount			**12,500**
Calculation of Federal Income Taxes (FIT):			
Corporate Income Tax @ 21% of Taxable Income	(21,000)	(21,000)	
Add Credit to Reduce Taxes (Like a Tax Payment)	**-**	**12,500**	
Payment (Due) IRS	**(21,000)**	**(8,500)**	
Equals: Net Operating Income After FIT	**$ 79,000**	**$ 91,500**	

Exhibit #1 - R&D Tax Credit Calculations

Five Reasons to Hire an Attorney-CPA

1. **Unparalleled Perspective.** Dually licensed Attorney-CPAs have training in multiple disciplines allowing them to view your matter from more angles than most professionals.
2. **Uniquely Qualified.** Only a small number of professionals achieve dual licensing, setting Attorney-CPA's apart from their peers in both industries due to the continuing education demands of a dual license.
3. **First-Class Education.** An Attorney-CPA especially values education, as such Attorney-CPAs are up to speed on the latest developments in their industries.
4. **Best of Both Worlds.** Two professions in one professional bridges the gap between your legal and financial requirements.
5. **A Practical Solution.** Save time and money by hiring a single dually licensed Attorney-CPA who is qualified to handle diverse business responsibilities including taxation, accounting, and legal.

Meet Our Team

Paul H. Burgess, Attorney & Certified Public Accountant

Paul has been a CPA since 1985 and added Attorney at Law to his qualifications in 1993 upon graduating from the University of Tulsa School of Law. He produces periodic tax newsletters on the latest changes in tax and business laws. He is a member of the American Academy of Attorney-Certified Public Accountants, the Oklahoma Bar Association, Oklahoma Society of CPAs, and licensed to practice before the U.S. Tax Courts and the Northern District of Oklahoma.

Theresa Ruth, Certified Public Accountant

Theresa started with Paul H. Burgess & Company in 2015. She is an accounting graduate from the University of Iowa, which is consistently ranked as one of the best accounting programs in the country by the Public Accounting Report. Theresa's three decades of experience in tax, accounting, management, and oil and gas is the right blend for our diverse practice.

Mackenzie Martin, BSBA

Mackenzie began working as the Tax & Legal Assistant for Paul H. Burgess & Company in 2021. She graduated Summa Cum Laude from Oklahoma State University in 2017 with a Bachelor of Science in Business Administration majoring in Entrepreneurship. Her duties include preparing and processing individual and business taxes, corresponding with clients and various agencies, and conducting research for litigation.

Marisa Baroni, Office Manager

Marisa has been a member of Paul H. Burgess & Company since 2022, bringing with her an extensive background in customer service from banking and other professional environments. She is passionate about finding solutions to any challenge as she oversees client relations and manages billing.