

Feature Articles

July, 2006

From Our Finance Issue

The R&D Tax Credit

by Jeff Corey



Recently a local CEO received a substantial refund check from the IRS for a research and development credit just because his firm developed a new process that made the company more productive. The firm does not wish to release its name or the size of the check (it was quite substantial), but we can say this much—the company is not a whiz-bang high-tech firm, or a place populated by people wearing white lab coats, or even a fancy cutting-edge research facility—it's a good solid company that's an innovator in its industry.

In the early 1980s, the IRS finalized the first Federal R&D Tax Credit program. The intent of this new program was to provide incentives for U.S.-based companies to develop innovative products and processes new to the world—typically patentable concepts and activities that would advance a school of thought in a natural science. The most technologically sophisticated companies quickly adopted this program across the country.

The challenge in capturing the credit, however, was two-fold. First, the activities had to pass the Discovery Test—a difficult IRS evaluation used to validate that the activities were indeed supporting a truly innovative idea. Second, the company had to maintain detailed, contemporaneous documentation of the activities to demonstrate a paper trail of the work. Both of these requirements precluded most mid-market companies from utilizing the credit.

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In 2001, however, the Treasury Regulations under Section 41 of the Tax Code proposed modifications to further encourage investments in companies and to stimulate innovation in the market. These regulations, finalized in December of 2003, removed both the Discovery Test and the requirement for contemporaneous documentation. As a result, these modifications expanded the definition of Qualified Research Expenditures (QREs), which included many activities involved in manufacturing, design, and production processes.

These changes to the tax statute provide the following benefits to companies paying U.S. taxes:

- Immediate source of significant cash
- Permanent tax savings

- A vehicle to achieve additional tax savings in future years
- A reduction to the overall effective tax rate
- Increased cash flow and earnings
- Greater market value for public entities

Most companies and their accountants, including many Fortune 500 entities and their subsidiaries, do not take full advantage of this tremendous opportunity. Companies—public and private, large and small—can qualify for the R&D Tax Credit. Broad arrays of activities qualify, including many day-to-day expenditures. The R&D Tax Credit is not a deduction; it is a dollar-for-dollar credit. The R&D Credit is available retroactively to all open tax years.

Should the taxpayer be in a net operating loss or alternative minimum tax position, the credit can carry forward 20 years. Government-sponsored economic stimulus programs/ R&D Tax Credits are not tax shelters. These economic incentives are government-sponsored programs and are backed by the Internal Revenue Service, Congress, and the current administration.

The credit today is for QREs in three broad categories—salaries and wages, supplies, and contractor fees—where a new business component was developed or an existing business component was improved. In general terms, a business component can be a product or a process, and can include the following:

- Manufacturing products
- Developing new, improved, or more reliable products / processes / formulas
- Developing prototypes or models (including computer generated models)
- Designing tools, jigs, molds, and dies
- Developing or applying for patents
- Performing certification testing
- Conducting testing of new concepts and technology
- Developing and introducing new technology
- Attempting the use of new materials and compounds
- Adding new equipment (labor and engineering cost aspects)
- Performing environmental testing
- Developing or improving production and/or manufacturing processes
- Developing, implementing, or upgrading systems and/or software
- Developing production control software
- Improving or building new manufacturing facilities
- Automating and/or streamlining internal processes
- Expending resources on outside consultants/contractors to do any of the above-stated activities

Based on the removal of the Discovery Test, which made it easier to qualify for research expenditures, and the removal of the need for contemporaneous documentation, many companies today qualify for significant federal (and possibly state) tax credits.

Although documentation of QREs is still necessary to support the credit, companies can develop the necessary documentation even after the activities have been

completed. By developing a Technical Report to substantiate the QREs, the necessary documentation requirement is fulfilled, and the maximum credit allowed under the current regulations is realized.

Today, many companies of all sizes, whether closely held or publicly traded, are taking advantage of the R&D Tax Credit and are receiving refunds back from the IRS, in some cases, substantial amounts of refunds. Eligible companies include:

- Manufacturers of all types
- IT hardware and software companies of all types
- Firms that invest in customized solutions for their clients
- Firms that make substantial investments for new or upgraded hardware or software where it is used directly in serving their customers.

If your company has invested in the development of a new or improved business component then you may have qualifying research expenditures under the Federal R&D Tax Credit program. In fact, you might just be surprised—not only that you qualify, but also at the size of the check you might receive.