Stealth Weapon: R&D Tax Credits

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Stealth Weapon: R&D Tax Credits

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Today's Moderator

Today's Presenters

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Introduction to the R&D Tax Credit

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- ✔ What constitutes R&D is much more expansive than what most business owners realize
- ✔ Originally signed into law in 1981, the scope of who qualifies has expanded thanks to new legislation, regulations, and numerous court cases establishing judicial precedent
- ✔ In 2003, the Discovery Rule was removed, meaning that research activities no longer had to be “new to the world”, but instead “new to the taxpayer” – a standard that is much more favorable to taxpayers
- ✔ In 2015, the Protecting Americans from Tax Hikes (PATH) Act not only made the R&D Tax Credit permanent, it modified the credit for the benefit of small and mid-sized businesses and opened up its availability to startups

Introduction to the R&D Tax Credit

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- ✔ How much is the R&D Tax Credit?
  - Benefit is generally between 6 and 8 cents to every qualified dollar
  - Dollar-for-dollar reduction in the company's federal tax liability
  - 1-year carryback and 20-year carryforward
  - Claim on amended return for open years
  - Many states also have R&D tax credits

Introduction to the R&D Tax Credit

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- ✔ What is the R&D Tax Credit?
  - A tax credit provided by the IRS to companies that focus on:
    - Creating new or innovative products
    - Improving existing products
    - Developing processes, patents, prototypes, or software
- ✔ R&D needs to attempt to discover technological information lacking to the taxpayer who is trying to develop or improve a business component's functionality, performance, reliability, or quality

Who Qualifies?

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✔ Credit is available to various types of industries

- Manufacturers
- Architecture & engineering firms
- Software development
- Food and beverage
- Distribution
- Pharmaceuticals
- Energy production
- Many more…

What Activities Qualify?

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Permitted Purpose The activity relates to a new or **improved function, performance, quality, reliability or manufacturability** of a product, process, computer software, technique, formula, or invention, which is to be held for sale, lease, license, or used in your trade or business ("business component")	**Process of Experimentation** Substantially all of the activities must be elements of a **process of experimentation** involving: • Evaluation of alternatives • Refining or discarding of the hypotheses • Systematic trial & error, testing, modeling, simulation, prototyping
Elimination of Uncertainty The activity must be intended to discover information to eliminate technical uncertainty concerning the **capability, method, or appropriate design** for developing or improving the business component	**Technological in Nature** The activity performed must fundamentally rely on **principles of hard sciences**, such as: • Physical science • Biological science • Computer science • Engineering • Mathematics

Examples of Qualified Activities

- ✔ To advance the design of an existing product or process
- ✔ To correct significant design defects, obtain significant cost reductions, or **improve functionality**
- ✔ Design, construction and testing of pre-production **prototypes** and models
- ✔ Conceptual formulation, design and testing of possible product or process alternatives
- ✔ Launch activities involving a new component/process

Examples of Qualified Activities

- ✔ Design time, tool design and testing, prototype building, etc.
- ✔ Engineering efforts to develop **new plant processes**
- ✔ Efforts to solve production problems where there was uncertainty as to the best solution
- ✔ The design and testing involved in improving the configuration or altering the composition of an existing product/process to **increase efficiency**
- ✔ **Integration** of new software platforms or programs with existing systems

Examples of Non-Qualified Activities

- ✔ Research done outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States (“offshore research”)
- ✔ Research in the social sciences, arts, or humanities
- ✔ Market and consumer research
- ✔ Changes related to style, taste, cosmetic, or seasonal design factors
- ✔ Ordinary testing or inspection of materials or products for quality control
- ✔ Advertising or promotion expenses
- ✔ Management studies and efficiency surveys

Examples of Non-Qualified Activities

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- ✔ Acquisition or improvement of land or of certain depreciable property used in research
- ✔ Acquisition of another person's patent, model, production, or process
- ✔ Research funded by another person, or any governmental entity, by means of a grant or contract
- ✔ Research conducted after commercial production
- ✔ Research for the adaptation or duplication of existing business components

What Expenses Qualify?

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- ✔ Wages
  - Box 1 W-2 Wages for employees involved in:
    - **Direct Performance** of qualified activities
    - **Direct Supervision** of qualified activities
    - **Direct Support** of qualified activities

What Expenses Qualify?

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- ✔ Supplies
  - Raw materials used in the research or experimentation process
  - Expenses relating to tangible personal property of a non-depreciable nature
  - Must be used or consumed in the research process
- ✔ Contract Research
  - Research conducted on behalf of the taxpayer (paid consultants)
  - Payments must not be contingent upon the success of the research
  - Taxpayer must retain substantial rights to use the research results
  - Allowed at 65% of the actual cost incurred

Research Credit Keys to Success

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PROJECTS

Permitted Purpose

Technological in Nature

Eliminate Uncertainty

Process of Experimentation

COSTS

<u>Wages</u>
Qualified Research
Direct Support
Direct Supervision

<u>Supplies</u>
Raw materials used in research

<u>Contract Research</u>
Research performed on your behalf

DOCUMENTATION

<u>Sample Documents</u>
Project List(s)
Time Tracking
Prototype Designs
Test Results & Analysis
Project Schedules/Timelines
Meeting Minutes
Executive Presentations
Project Summaries
Customer Contracts
Engineering Notes
Project Budgets
Requirement Documents
Email Correspondence

Lifecycle of an R&D Tax Credit Study

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- ✔ Initial meeting to discuss potential opportunity, discuss what qualifies as research for the credit and gain an understanding of specific activities the business is undertaking that may qualify
- ✔ Information is requested to provide complimentary tax benefit assessment and fixed fee proposal
- ✔ Requested info includes: time study, profit & loss statement, three prior year tax returns, organizational chart, etc.

Lifecycle of an R&D Tax Credit Study

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- ✔ Fixed fee proposal and estimated credit range are provided
- ✔ Employee interviews are conducted to document how the expenses meet the 4 Part Test and gather additional wage/supply/contract allocations
- ✔ Federal credit figures are delivered with a draft Form 6765 needed to claim the credit on federal tax return
- ✔ Applicable state credit applications are delivered

Lifecycle of an R&D Tax Credit Study

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- ✔ Maintaining **documentation** is a key component of claiming the R&D tax credit & sustaining upon audit
- ✔ IRS requires that each business component satisfy the 4-part test
- ✔ Documentation should be maintained to help support and substantiate:
  - Qualifying activities **AND**
  - Costs associated with qualified activities

Examples of Documentation for Activities

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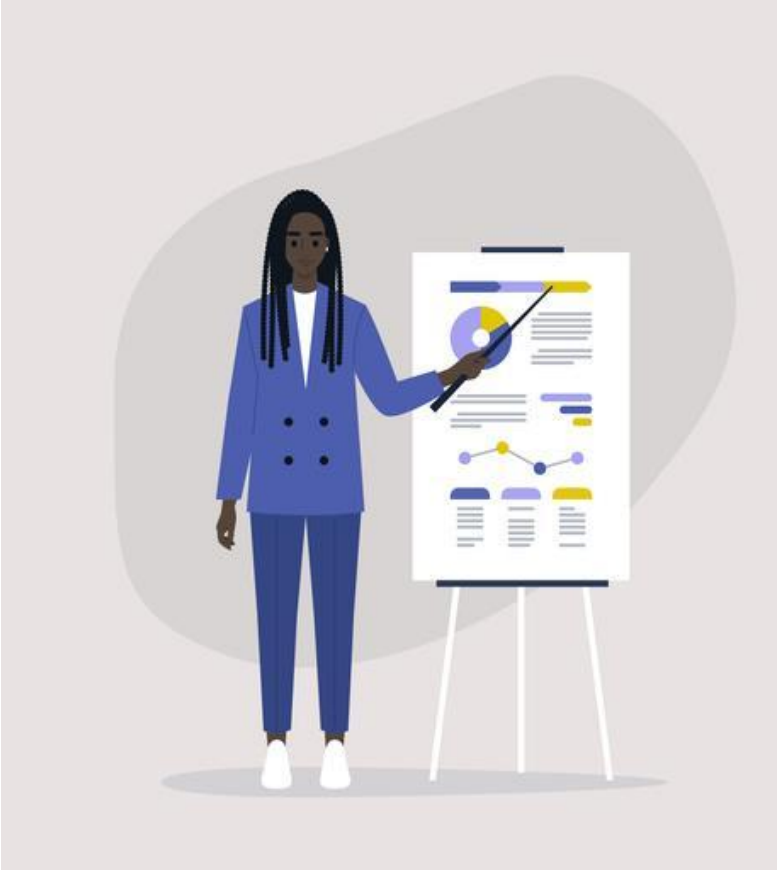
- ✔ Test results of experiments
- ✔ Hand sketches, design concept **drawings**, CAD designs showing the evolution of product designs
- ✔ **Presentations and summaries** to management, the board of directors, review committees or other similar groups regarding research projects, activities, expenditures and the credit
- ✔ **Meeting minutes, notes**, or other similar recordings from budget, board of directors, managerial or other similar meetings concerning research activities



Examples of Documentation for Activities

- ✔ Project authorizations, budgets or work orders that initiated the research project
- ✔ Internal authorization policies for approving a research project
- ✔ Project summaries, **progress & milestone reports** and project notes (informal)
- ✔ Email **correspondence** describing technical challenges

On the Horizon

- ✔ Changes in 2022 to deduction of **§174** research and experimental ("R&E") expenditures
  - Tax Cuts and Jobs Act (TCJA) – revenue raiser
  - **Currently**: Taxpayer may immediately expense R&E costs in year paid or incurred
  - **2022+**: Taxpayer must amortize R&E costs over 5 years (15 year period for foreign-based costs)

On the Horizon

- ✔ Planning for the change to §174 cost treatment
  - Identifying R&E expenditures, bifurcating between US and foreign
  - Potential increase to taxable income and estimated tax payments beginning in 2022
  - Bipartisan proposals to repeal or delay the change

Case Studies

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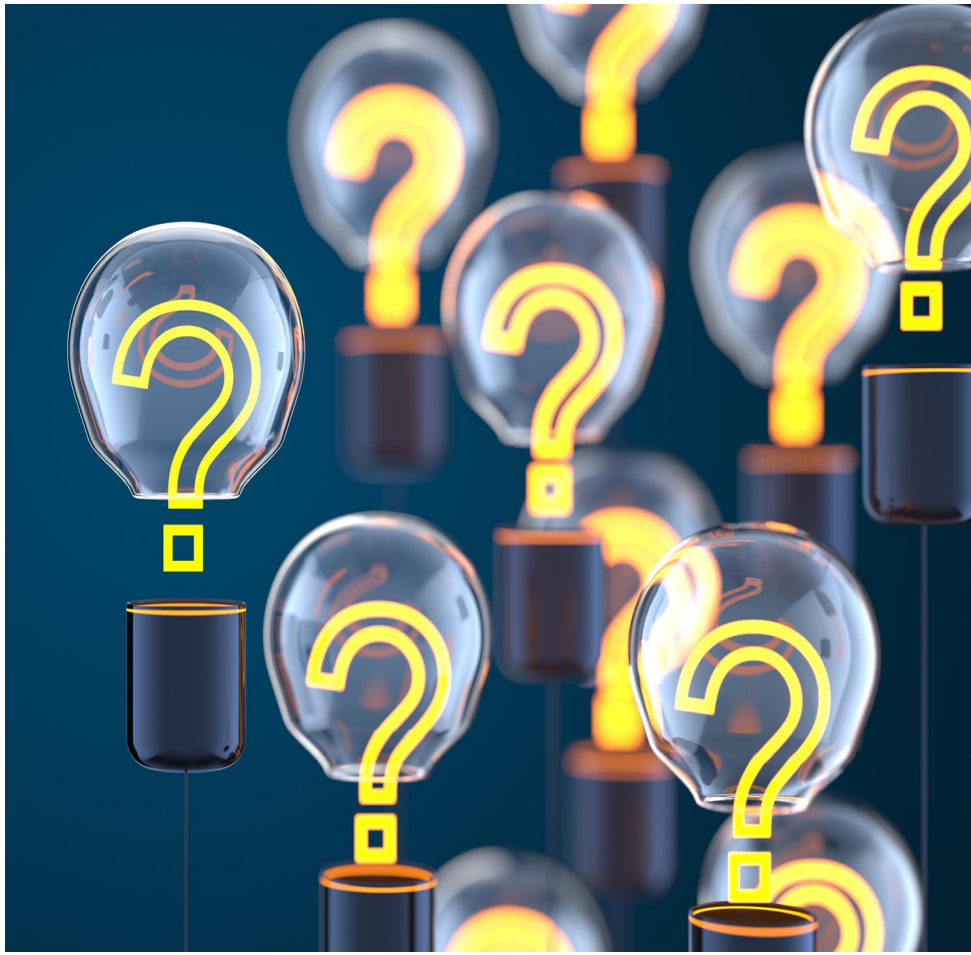
	Tax Year	Gross Receipts	Qualified Research Expenses (QRE's)	R&D Credit	Credit as % of QRE's
Engineering	2018	$16,574,877	$3,099,258	$192,154	6.2%
Engineering	2019	$14,754,124	$2,956,577	$153,742	5.2%
Engineering	2020	$17,534,222	$3,142,745	$172,851	5.5%
Manufacturing	2018	$14,251,225	$939,720	$77,057	8.2%
Manufacturing	2019	$8,354,355	$744,919	$46,185	6.2%
Manufacturing	2020	$12,455,114	$1,008,310	$84,698	8.4%
Software Development	2018	$21,018,998	$324,754	$18,511	5.7%
Software Development	2019	$18,188,900	$450,089	$35,557	7.9%
Software Development	2020	$27,557,357	$412,463	$27,635	6.7%

FAQ

- ✔ What if my company isn't profitable?
- ✔ What if the research endeavor fails?
- ✔ What if I don't think our business is doing R&D?
- ✔ Can I offset state taxes in addition to federal?
- ✔ Can the credit be claimed for a prior year?
- ✔ What is the risk of audit?
- ✔ What is the value in partnering with a CPA firm for R&D?



Questions

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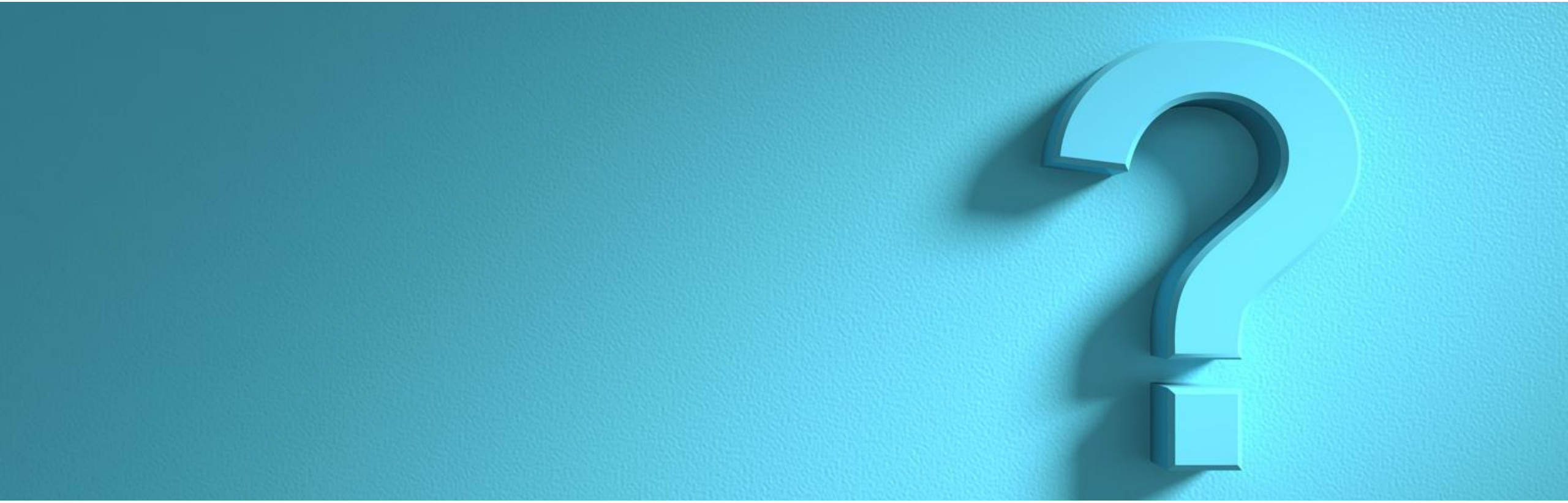

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