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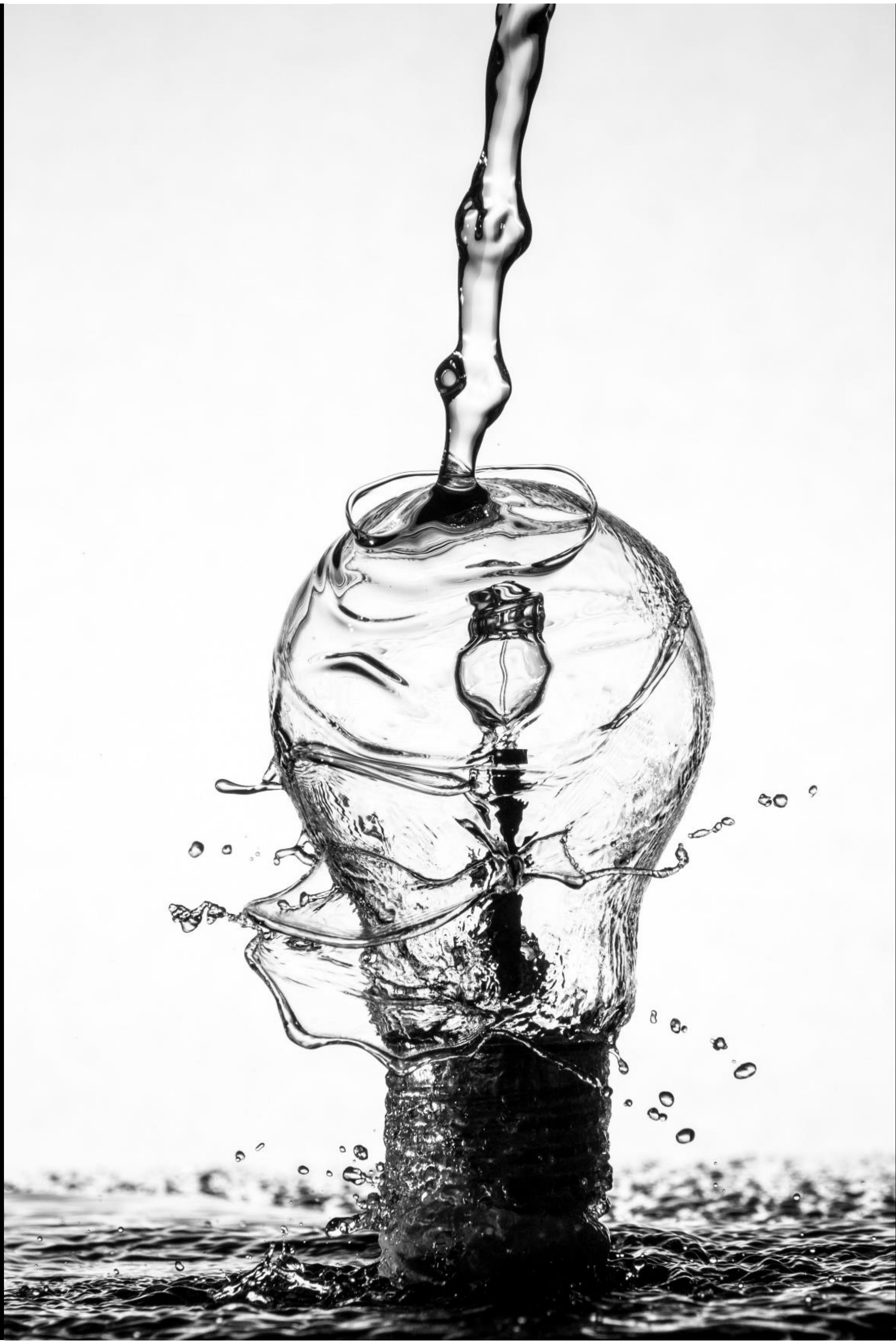

Pay Less, Invest More

A GUIDE TO RESEARCH & DEVELOPMENT CREDITS

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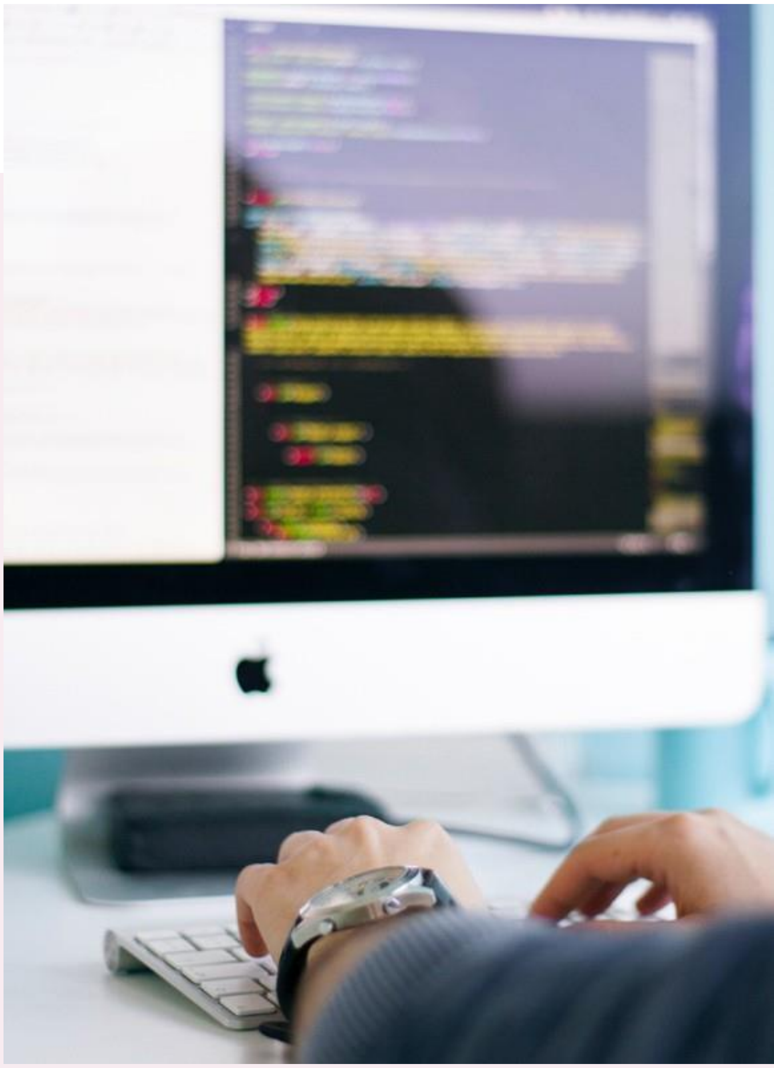


Overview

Research and development (R&D) credits return billions of dollars in federal and state benefits to companies engaged in innovative research and experimentation. Available to United States taxpayers in an unlimited amount, these lucrative credits go unclaimed by companies with eligible expenses each year.

Since the early 1980s, the federal research tax credit (section 41) has been used to reward innovation and job creation on U.S. soil. In addition to federal credits, 34 states have enacted some form of research credits with varying rules of conformity to federal guidelines.

Recent federal changes have opened the floodgates for companies of all sizes to benefit in various ways from R&D credits.

Any company that develops new or improved products, processes, or software—in some cases, whether profitable or not—may qualify for these lucrative credits.

The R&D tax credit is not a deduction. It is a dollar-for-dollar credit against taxes for qualifying expenses incurred in performing qualifying activities. The credit itself can return 5.5 to 8 cents for every dollar spent in qualified wages, supplies, or contract expenses above a determined, taxpayer-specific base amount. As a result, a start-up software company with six engineers performing qualified work could realize $30,000 in R&D credits. A medical device company with hundreds of engineers may receive well over $1 million in R&D tax credits.

Overview

Larger companies that are better informed and more aggressive tend to make more claims than smaller companies. Many small to mid-size companies may not realize they qualify for the credit, or are intimidated by the complex rules, documentation requirements, and calculation mechanics governing the credit. Still others may lack the time, resources, or expertise necessary to identify and manage R&D credit claims.

The IRS takes a hard line on credit filings. An amended tax return or large R&D credit may trigger an IRS audit that could result in penalties against the corporate taxpayer or a return preparer for any unsubstantiated claims.

Taxpayers must understand the ins and outs of R&D credits – eligibility, calculation details, documentation, and filing requirements – before pursuing R&D credits.

RECENT DEVELOPMENTS

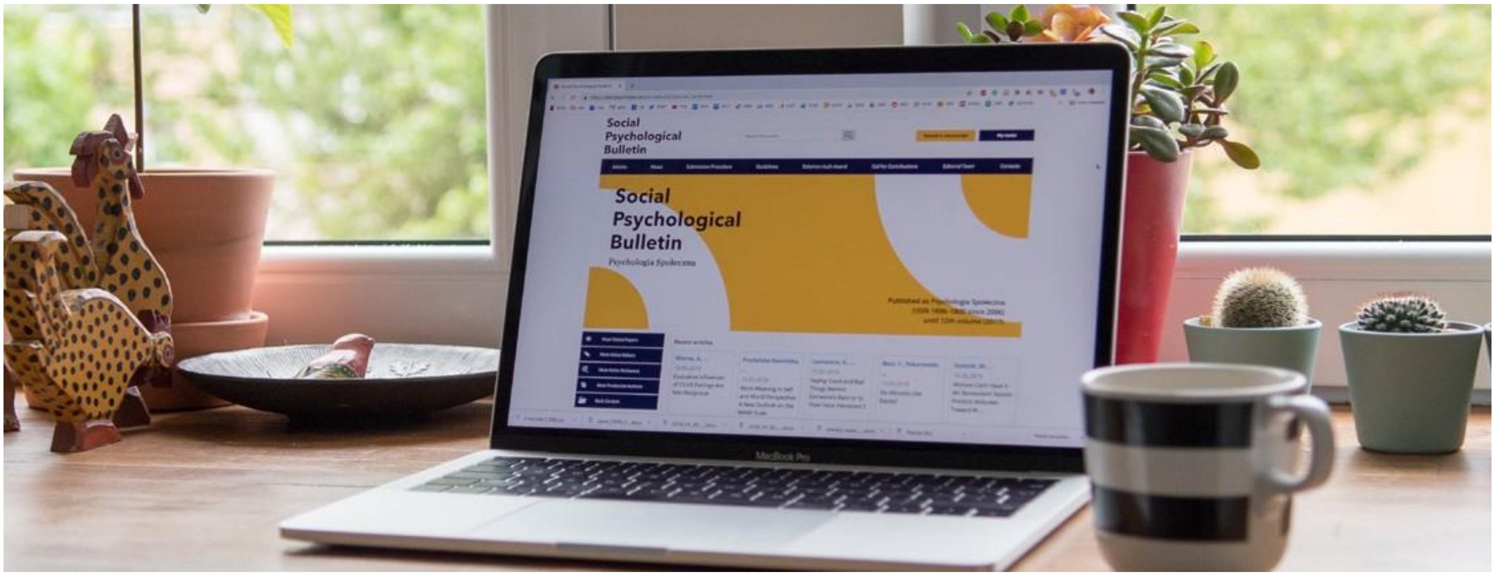
The Protecting Americans from Tax Hikes (PATH) Act of 2015 made the federal research credit permanent, ending a long cycle of temporary extensions and giving companies more certainty in factoring credits into financial planning.

PATH also expanded eligibility to smaller and newly launched companies, who may be eligible to apply for credit against their payroll tax for up to five years starting in 2016. The payroll tax offset is available to companies with gross receipts for five years or less; less than $5 million in gross receipts in 2016 and each subsequent year credit is elected; qualifying activities and expenses; and, payroll expenses.

Summary

- The R&D tax credit is a dollar-for-dollar credit against tax
- Qualifying companies must be engaged in technological activities directed at developing a new or improved business process, component, or software
- Companies engaged in a wide variety of activities across U.S. business sectors may be eligible
- Recordkeeping and documentation are critical to justifying expenses to the IRS
- In recent years, Congress made the R&D credit permanent, eliminating financial planning uncertainty for companies engaged in day-to-day qualifying activities
- In addition to federal credits, 34 states have enacted some form of research credit

Changes in the IRS LB&I Directive provides a safe harbor from IRS challenge in the amount a qualifying taxpayer claims in federal credit. Only taxpayers with more than $10 million in assets that follow U.S. generally accepted accounting principles (GAAP) in preparing certified financial statements qualify for this streamlined audit procedure.



Qualifying Activities

Four tests must be met for activities to qualify for federal research credits. Internal-use software development activities are qualified under additional criteria.

TECHNICAL IN NATURE

Activities performed must be based on hard sciences, such as engineering, physics, or computer science

QUALIFIED PURPOSE

Activities must be aimed at developing a new or improved business component based on functionality, performance, or quality

PROCESS OF EXPERIMENTATION

Activities must include an experimentation process built around trial and error

TECHNICAL UNCERTAINTY

Activities must be performed to eliminate technical uncertainty in the development or improvement in a product, process, or software

Whether the outcome reflects failure or success, if a process of experimentation is involved, activities can be qualified.

RESEARCH ACTIVITIES

Companies that benefit from the research credit may be engaged in a variety of activities across U.S. business sectors, including the following:

- Aerospace
- Agriculture
- Biotechnology
- Chemical
- Electronics
- Energy
- Engineering
- Fabrication
- Food sciences
- Information technology
- Machine shops
- Software
- Technology
- Pharmaceutical
- Tool and die

Qualifying Expenses

The credit applies only to eligible expenses, known as “qualified research expenditures” (QRE), and includes in-house wages, supplies, leased computer costs, and contract labor associated with qualified research that exceeds a determined, taxpayer-specific base amount of R&D spending. Prototype expenses may be included in most cases.

Amounts paid for salaries, supplies, contract research, and computer leasing could all qualify for R&D credits. Indirect costs such as overhead, travel, education, taxes, or capital expenditures are not included.

Calculating the Credit

Calculation methods, incentive amounts, and rules vary by jurisdiction. In general, however, the credits are calculated using one of two credit formulas. R&D costs incurred in years when a company has no income can be carried forward to offset tax on future profit up to 20 years. Federal taxpayers can also claim R&D credits retroactively by filing amended returns.

TRADITIONAL METHOD

Corporate taxpayers receive a 16 percent tax credit for qualified R&D expenses in excess of a calculated base amount. The base amount is determined by a statutory formula using the taxpayer’s prior year gross receipts and qualified research expenditures.

ALTERNATIVE SIMPLIFIED CREDIT METHOD (ASC)

The ASC method uses the taxpayer’s historical (three prior years) R&D spending instead of gross receipts to calculate a credit.

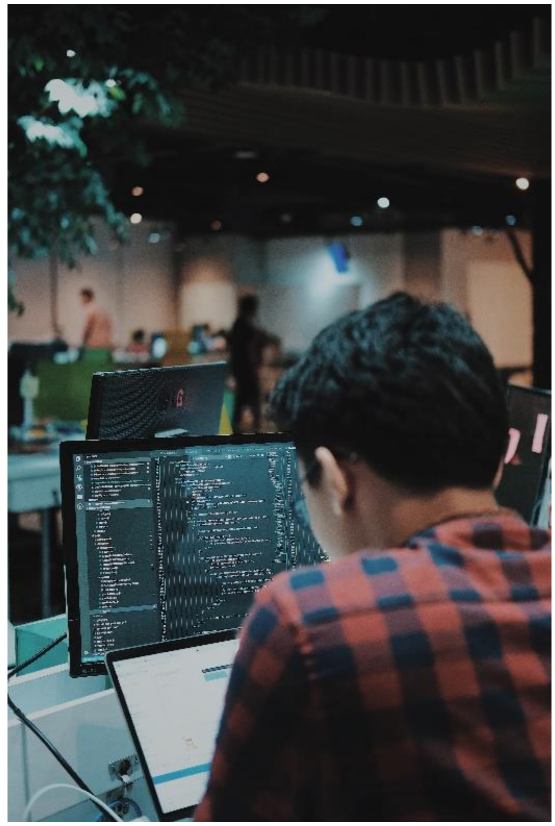
Documentation Requirements

The recordkeeping and documentation requirements for the R&D credit are critical to justifying expenses to the IRS. Contemporaneous documentation must be maintained to support qualifying activities each year. Technical analysis should be completed before the return is filed. All workpapers and credit computations should be similarly documented and readily available for audit review. Additional documentation should include evidence of the following.

- ***Qualified activities.*** *During audit, engineering experts may be sent in to confirm the qualified basis for the credits through a review of contemporaneous documentation around the credit calculation and items the taxpayer used to justify eligibility for the credit claim.*

- ***Evidence linking expenses to activities.*** *The IRS is interested in documentation that connects a company's qualifying expenditures and qualifying activities. Documentation should directly link the project to the employee and the time spent on that project for each specific year.*

- ***Experimentation is taking place.*** *Testing reports that identify the problem and testing outcomes should be maintained. Tests that result in product failures should be included as these efforts may demonstrate the cutting-edge development taking place at a company.*



Frequently Asked Questions

Is there any cap on the dollar amount of R&D credit?

There is no cap on U.S. research credits. Credits that cannot be used in the current period can be carried back one year and forward 20 years. Taxpayers may amend prior year returns to claim tax credits when the tax year is open for assessment of tax. Prior approval of projects or activities is not required.

Does the receipt of research funding disqualify a company from also receiving an R&D credit for the same project?

No. Companies that receive federal funding from a grant program can net the proceeds against expenses. Companies that receive compensation from a customer may also be able to claim all the expenses as a credit. The determining factors are that the company maintain rights to the intellectual property and be at risk for the costs.

Does claiming the research credit trigger an IRS audit?

If a taxpayer files an amended return and claims a refund due to a research credit, the company is likely to be subject to an audit. However, a research credit included in a timely filed original return has no better chance of being audited than any other tax return. Nevertheless the R&D credit continues to be an area of focus for the IRS and state examiners. Filing for the R&D credit doesn't guarantee you'll get the credit. The nature and content of your documentation and filings will dictate whether the IRS deems your activities credit worthy or not.

What if a company has a net operating loss?

The R&D credit is subordinate to net operating losses (NOLs) and alternative minimum tax (AMT) credits. Companies with NOLs deduct the losses first, and use any AMT credit next. After both items are used, the research credit can be applied against taxable income on a carryforward basis for up to 20 years. It is best to claim the credit on the originally filed return and use that credit when the company becomes taxable.

Frequently Asked Questions

Can a company receive a cash benefit for research credit even though the company is not paying tax?

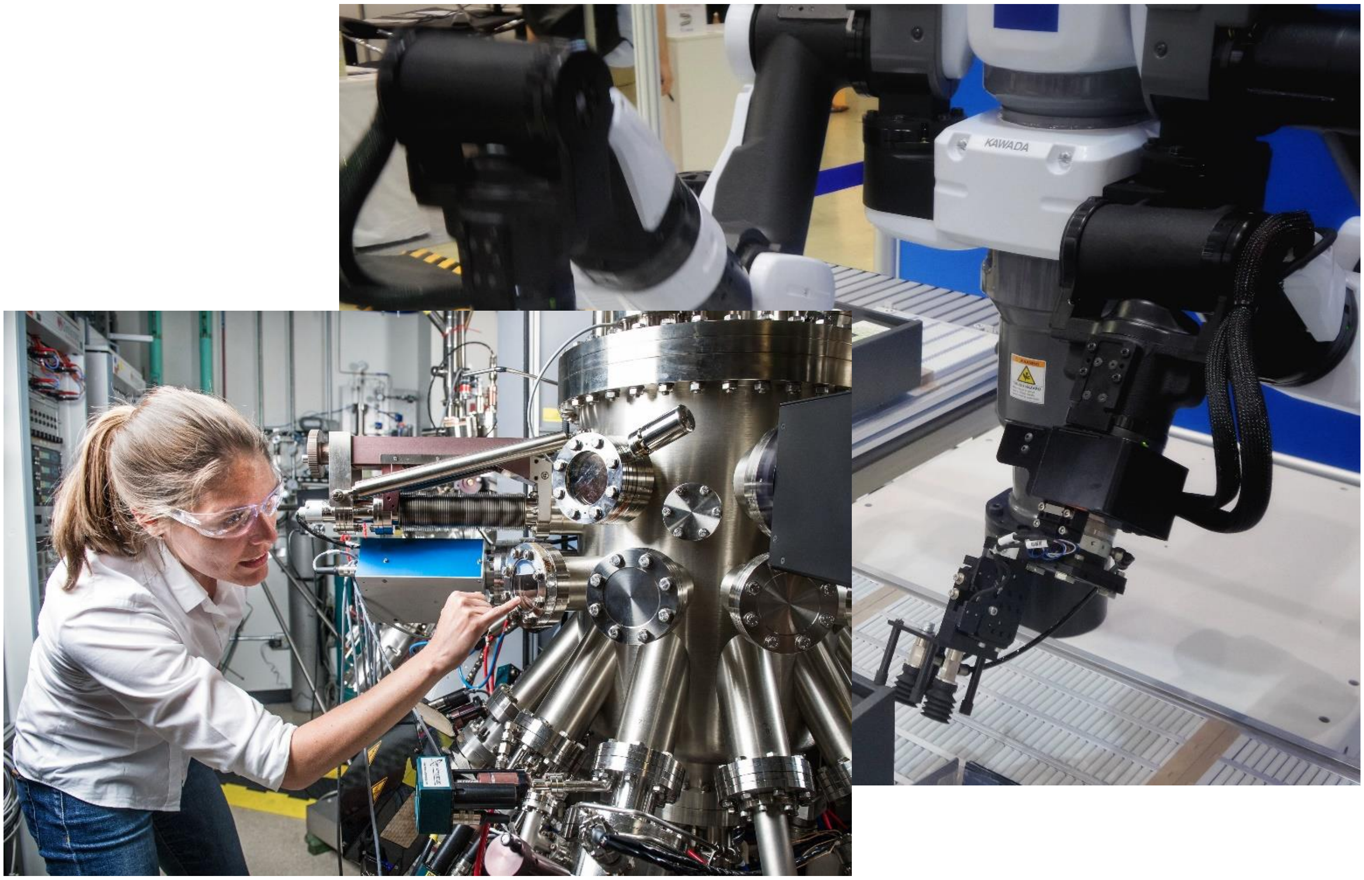
For medium or large companies, the answer is no. The research credit is not refundable for cash. The research credit is used against taxable income only net of NOL and AMT. Starting with the 2016 tax year, small businesses (three prior year average annual gross receipts of less than $50 million) are eligible to offset both their regular income tax and their AMT with the research credit. Furthermore for small and start-up companies also with the 2016 tax year, a taxpayer can elect to offset the R&D credit against payroll tax (the employer's portion of the 6.2% Social Security tax) which is especially beneficial for companies with little or no income tax liability. To take the credit against payroll taxes, a business must have gross receipts of $5 million or less in the tax year of the claim and no gross receipts in any tax years preceding the last five years (including the year of the claim).

What is the significance of the section 280C election on the credit?

Years ago, the research credit benefit was reduced by requiring taxpayers to add back into income the amount of the credit in the year the credit was generated. A separate option was introduced allowing companies to take a "reduced credit" or in other words elect to file 280C. The 280C election was designed to have the same net benefit with fewer administrative hurdles. The 280C reduction election must be made on an original, timely filed tax return. This election cannot be made on an amended return. Once made, the election is irrevocable.

Can the R&D credit be estimated?

No. Companies must take the time to document and support the research activities and to quantify the credit. Companies that simply estimate the credit on their tax return risk disallowance of the credit entirely as well as penalties that can amount to up to 20 percent of the credit claimed by the taxpayer (IRC Section 6662).



Complimentary benefit analysis

Don't leave lucrative R&D credits on the table. To learn more and find out what your potential federal and state research credit is worth, contact us directly or visit us online.

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Visit us at taxops.com/minimization.

About TaxOps Minimization

We've been maximizing federal and state research and development credits at global businesses for more than two decades. Our industry-leading experience, audit-ready techniques, and senior-level attention distinguish TaxOpsMin as a personalized and tax-efficient alternative to the Big Four. We'll be here year after year providing top-level support and work product we firmly stand behind.