Overview

Today’s presentation will address:

- Federal R&D Tax Credit (“R&D Credit”) facts and statistics
- Definition of “R&D” for tax credit purposes
- R&D Credit computational rules
- R&D Credit documentation requirements
- Proposed legislation for extending the R&D Credit
R&D Credit Facts & Statistics
R&D Credit Facts & Statistics

- The R&D Credit was first enacted in 1981
- The R&D Credit is a *temporary* credit that has been amended or extended by Congress ten times since its inception
R&D Credit Facts & Statistics (continued)

- The R&D Credit is one of the most significant federal tax benefits available to qualifying companies.
- Over $5 billion in R&D Credit claims are made by companies annually.
- Nearly 16,000 companies claimed the R&D Credit in 2000.
- An estimated 80-90% of these claims are made by Large and Mid-Size Business (LMSB) (i.e. total assets greater than $10 million).
- Companies in the manufacturing, services, and retail/wholesale trade sectors are among the largest recipients of the R&D Credit.
Definition of R&D for Tax Credit Purposes
“R&D Tax Credit” vs. “Qualified Research Expenditures (QREs)”

- The “R&D Tax Credit” claimed is the end result of the R&D Credit calculation process. To perform the calculation, “Qualified Research Expenditures” (QREs) must be identified and tallied.

- Cost center/department expenditures must be examined in an effort to identify QREs. QREs are **specific costs** defined by the IRS as costs which qualify for the R&D Tax Credit.
Qualifying R&D Costs

- Employee **wages** associated with “qualified research and development” activity

- **Supplies** purchased for “qualified research” (property other than land, land improvements or capitalized property)

- 65% of **contract labor** costs associated with “qualified research and development”
What is “Qualified Research and Development”?

- The development of any **new** or **improved** business component of the Company (i.e. product, process, software, technique, formula or invention)

- To qualify, each activity must pass **all four** of the following “tests”:
  - Test Number 1: Code Sec. 174 Expense Treatment
  - Test Number 2: Discovering Information That Is Technological In Nature
  - Test Number 3: The Process of Experimentation
  - Test Number 4: The Purpose of the Research
Test Number 1: Code Sec. 174 Expense Treatment

- Research expenditures must be related to R&D in the experimental or laboratory sense.
- Activities meet this standard if they are intended to:
  - (1) Discover information that is not readily available to the taxpayer;
  - (2) Eliminate uncertainty either about capability or method of developing/improving the product, or about its appropriate design.
Test Number 1 (continued):
Code Sec. 174 Expense Treatment

- Additional Code Sec. 174 Requirements:
  - Expenditures must not be for land or depreciable property;
  - Contract research expenses are only eligible if the risk of the project remains with the taxpayer
Test Number 2: Discovering Information That Is Technological In Nature

- Research must be undertaken for the purpose of discovering information that is technological in nature.
- Research is technological in nature if it relies upon principles of the physical or biological sciences, engineering, or computer science.
- Final Regulations issued in December 2003 essentially eliminated the contentious “Discovery Test” formerly proposed by the IRS.
Test Number 3: The Process of Experimentation (POE)

- A POE is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result—or the appropriate design of that result—is uncertain at the outset.

- A POE must rely fundamentally on the principles of one or more of the “hard” sciences outlined in Test Number 2 and must involve identifying uncertainty concerning the development or improvement of a business component.
Test Number 3 (continued): The Process of Experimentation

- The taxpayer is required to identify and conduct a process of evaluating the alternatives through, for example:
  - Modeling
  - Simulation
  - Systematic Trial and Error

- “Substantially all” rule – if 80% or more of the research meets the requirements for a POE, credit can be taken for all activities conducted.
Test Number 4:  
The Purpose of the Research

- Research must be performed for a purpose that relates to (1) a new or improved function, (2) performance, or (3) reliability or quality

- Research relating to style, taste, cosmetic, or seasonal design factors are specifically excluded from the credit

- Cost reduction is not specified in the statute as a qualified purpose, but a strong argument can be made that research which delivers the same performance at a reduced cost is an improvement in performance
Examples of Qualifying Activities

- Concept formulation
- Technical feasibility analysis
- Product development/packaging design
- Pilot plant/prototype development
- Testing (pilot plant)
- Redesign
- Testing (at plant sites)
- Process development/improvement
- Patent application work
- Direct supervision of any of these activities
- Direct support of any of these activities
Examples of Non-Qualifying Activities

- Administration
- Training
- Routine engineering/software maintenance activities
- Activity conducted outside of the United States
- Activities relying upon the social sciences, arts or humanities
- Research after commercial production has commenced
- Adapting existing components to a particular customer need
- Duplicating an existing component via reverse engineering
- Routine data collection or ordinary testing for quality control
- Conducting any efficiency survey, activity relating to management technique, or brand development (including advertising or promotions)
- Activity related only to style, taste, cosmetic or seasonal factors
R&D Credit
Computational Rules
R&D Credit Computational Rules

- The R&D Credit is an incremental credit structured to provide a benefit only for research expenditures that exceed a base level of expenditures.

- The incremental nature of the R&D Credit makes identifying all Qualified Research Expenditures ("QREs") a critical aspect of each year’s credit calculation.
Standard R&D Credit Calculation (Overview)

- Compute current-period QREs
- Compute the “base amount”
  - the “fixed base %” is the % of aggregate QREs to aggregate gross receipts for tax years 1984 through 1988
  - multiply the “fixed base %” by the average annual gross receipts for the previous 4 years
- Take the excess of QREs over the base amount and multiply by 20%
- Perform separate calculation for basic research payments (universities and research consortia)
Alternative Incremental Research Credit (Al RC) Calculation (Overview)

- Compute current-period QREs
- Compute the average annual gross receipts for the previous 4 years
- This data is broken into 3 tiers with a tax credit rate applied to each tier
- Credit rates are graduated—they increase as QREs increase (more R&D expenditures = larger tax credit)
- Final tax credit is the sum of the amounts calculated in each tier
Why Elect One Calculation Method Over the Other?

- The calculation of fixed base % and base amounts necessary for the standard calculation can be extremely burdensome.
- If gross receipts are increasing as R&D spending hits a plateau, the R&D Credit calculation will be negatively impacted.
- The AIRC resolves these issues, however, electing to use the standard calculation might result in a larger credit.
- Note: once a method has been selected, it can only be changed with IRS consent.
Factors That Can Impact the R&D Credit Calculation

- Anomalies in gross receipts or QREs during the 1984 to 1988 base period
- The interplay of claiming a “full” credit or a “reduced” credit and the effect of the Code Sec. 174 deduction as a result (add-back to gross receipts)
- Mergers and acquisitions (the “consistency rule”)
- Expiration of the credit for portions of a tax year
- Changes in internal tracking data (accounting systems, accounting methods, etc.) that can lead to consistency problems (again, the “consistency rule”)

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R&D Credit
Documentation
Requirements
Why is Documentation Necessary?

- Documentation supporting the R&D Credit amount claimed is required by the Internal Revenue Service as well as State Revenue Departments.

- Without proper documentation, companies risk losing the tax benefit associated with the credit.
The governing statute for R&D Credit documentation is Code Sec. 6001 which simply requires taxpayers to maintain permanent records necessary to establish the amount of credit calculated.

The exceedingly general nature of Code Sec. 6001 means that the taxpayer must anticipate the records the IRS will request upon audit.
Documenting the R&D Credit (continued)

- The key to a successful R&D Credit claim is thorough documentation.

- However, internal accounting and management data rarely provides all of the information necessary to support R&D Credit claims.
Documenting the R&D Credit (continued)

- Documentation must explain how the company is meeting the 4-part test for “Qualified Research and Development”
- Documentation must also clearly explain the **nexus between qualified activities and costs**
Proposed Legislation for Extending the R&D Credit
Current Status of the R&D Credit

- The R&D Credit expired on June 30, 2004
- Legislation has already passed the Senate and House to extend the credit through December 31, 2005
- Senate and House bills agree on the extension date but differ in other areas
Proposed Legislation (Senate Bill)

- In addition to extending the R&D Credit through December 31, 2005, the Senate bill:
  - Increases AIRC credit brackets to 3, 4, and 5% (from 2.65, 3.2, and 3.75%)
  - Introduces a new Alternative Simplified Credit
  - Expands credits for amounts paid to energy-related research consortia
Proposed Legislation (House Bill)

- The House bill extends the R&D Credit through December 31, 2005
- No structural changes to the R&D Credit are currently included in the House bill
Current Status of the R&D Credit (continued)

- The R&D Credit has broad bipartisan and bicameral support and is also supported by the White House.
- It is **VERY** likely the R&D Credit will be extended and the credit will likely be retroactive (there is no blackout period indicated in current legislation).
- If R&D Credit legislation is not passed by October 2004, it will likely not be up for consideration again until February 2005.
For Further Information...

If you have questions regarding the R&D Tax Credit or would like to explore your options for calculating and documenting R&D Credit claims, please feel free to contact me:

Eric Bates
Professional Tax Contracting Services
(925) 371-2795
eric@taxcontracting.com
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