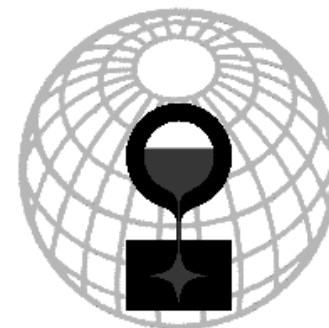


Steel Founders' Society of America



Research & Development Tax Credit Overview

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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 (AIRC) 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”)

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

Documenting the R&D 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:

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