

R&D Tax Credits: Not Just for Big Companies

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There is a misconception that the federal research tax credit applies only to large corporations with labs, white coats and million-dollar research budgets. In fact, the credit can be used by a variety of companies in different industries and can save you money even if you spend five figures a year on research and development.

The reality of the research tax credit is that the largest corporations – in 2005 more than half of the \$6 billion of net credit was used by 549 larger corporations – dominate use of the incentive. It doesn't have to be that way. Take the case of a mid-sized packaging company in Colorado.

A Colorado manufacturer that sold fishing equipment to Wal-Mart had been required to make packaging biodegradable because fishermen were discarding the old non-biodegradable packaging in the wilderness. The manufacturer sought help from a packaging company for the solution. In order to design the package, research biodegradable materials, design the label and test market the final product, the packaging company spent \$850,000. Everything went well and the end client – Wal-Mart – accepted the product and the environment is presumably the better for it.

The research tax credit is exactly that, a direct reduction dollar-for-dollar of the income tax, not a tax deduction. Normally it amounts to about 6.5 cents on the dollar invested. In this case, the packaging company earned about a \$50,000 reduction on its tax bill.

Good news, bad news and the catch

Now here's the good news, bad news and the catch. First the catch: The research tax credit is a temporary credit authorized by Congress, renewed every year. Fortunately, Congress has extended the tax credit every year since it was initiated in 1981 with the exception on one six-month period in 1996.

Here's the bad news: Qualifying for the credit can be complicated and takes some expertise to navigate through the Internal Revenue Code and document everything in order to qualify for the credit. In 2009, the Government Accountability Office (GAO) did research that showed that the credit is failing to motivate taxpayers because of poor guidance. They are uncertain about documentation requirements and this has led to disputes between the IRS and the taxpayer. Unclear definitions, recordkeeping costs, and the resulting uncertainty leave the taxpayer hesitant to use the credit.

There are four basic rules to qualify an expense as research. You have to:

1. Create a new or improve an existing product, process or component of a product or process;
2. Use principles of science in the research;
3. Have some level of uncertainty as to the capability, method or design of the end product or process;
4. Involve a process of experimentation.

If you have an engineer or scientist on staff, the expense most likely will qualify as research. If you sub the work out, but retain the economic risk, it still qualifies, but not if you lay off the economic risk. Things should improve. The GAO recommended that the Treasury Department better define such terms as internal-use software, depreciable property, indirect supervision and gross receipts.

The good news is that most of your costs to qualify for the credit are up front. Once the program is in place, it takes very little tweaking to continue to reap tax benefits. More good news: you don't have to have revenue or income to qualify; you just have to pay federal taxes in order to use the benefit.

Who should use the credit?

I have clients who have two employees costing \$120,000 and spend \$400,000 more on R&D. They get an annual \$25,000 credit. Another client spent \$4,000 setting up the program with just a R&D expense, but their research investments would be increasing annually and their administrative costs will slow to a trickle. They'll receive the credit every year.

Which types of companies should investigate the tax credit? Let's say you are trying to make your product or service bigger, better, faster or smaller. If you and want to upgrade, the costs involved with developing new tanks could qualify. You could be an architectural or engineering firm developing new technology at your own risk. Renewable and bioscience companies are obvious candidates. Manufacturing companies usually have qualifying R&D expenses. It's worth a try. In today's economic climate, every dollar counts.