

Maximizing R&D tax credit savings

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What would \$100,000 or even \$1 million extra cash do for your bottom line? What if you knew that cash was just sitting in a drawer waiting for you to reach in and take it? Many engineering firms are doing exactly that. A powerful tax incentive known as the research and development (R&D) tax credit is available at both federal and state levels that can help engineering firms recover a significant amount of their R&D costs. Many engineering firms are actively pursuing this credit and putting their tax savings to good use in building their business. But other firms either have no idea that they would qualify for the credit or simply don't know how to go about claiming it.

Taking full advantage of R&D tax credits is a key to reducing federal and state tax liability significantly for many businesses. Since recent law and regulation changes have expanded the requisite definition of qualified R&D, the credits are applicable to activities associated with the design and development of buildings, structures, and mechanical and electrical systems — common activities in the engineering service firm industry. Furthermore — and perhaps most importantly — since there is no longer a requirement that qualified R&D include activities associated with revolutionary developments (the discovery rule was repealed in 2001), activities to design and develop structures and systems for specific applications may qualify. Specifically, pursuant to Internal Revenue Code Section 41 and its applicable regulations, activities that satisfy the following four requirements qualify for R&D tax credits:

- 1) Business Component Development (e.g., structures and systems)
- 2) Elimination of Uncertainty (e.g., final design uncertainty)
- 3) Process of Experimentation (e.g., design evaluations)
- 4) Technological in Nature (e.g., engineering principles)

Following are examples of how our firm, *alliantgroup*, helped engineering service firms maximize the R&D tax credits to which they were entitled.

Do R&D tax credits exist for me?

Many smaller and mid-size engineering service firms are unaware of tax credits that exist for their design and development work. One such client of ours was a \$15 million firm that provided civil, waterfront, and structural engineering design services to clients on a regional scale. Even with the more taxpayer-friendly changes in the law, this firm had no idea it was conducting qualified activities, and thus had never taken the R&D tax credit.

As an example of their R&D, this firm had undertaken a project to design and develop a bridge using unique materials for specific structural loads. Its engineers accomplished the project requirements through several iterations of hypothesizing a design, assessing the design through computer modeling and other engineering analyses, and redesigning based on evaluation results. Although this firm did not view the project as R&D by traditional notions, once it understood the true definition of Section 41 qualified research, and that qualifying projects need not meet a threshold of innovation rising to the level of revolutionary design or patentable invention, it realized that if it met the four-part test described above, it could be substantiated for claiming the R&D tax credit.

Did the bridge project meet the requirements?

First, there were unique functions of this particular bridge that established the business component development. Second, the project contained uncertainty with respect to the final design, and therefore met the elimination of uncertainty requirement, even though the firm was certain of its ability to accomplish project goals and its own method of development. Third, the firm did not necessarily need to construct physical prototypes to meet the process of experimentation test because its processes for evaluating one or more design alternatives satisfied it. Lastly, although the firm used known principles of engineering to conduct its design evaluations, that in no way disqualified the project from meeting the “technological in nature” test.

The bottom line is that the firm was able to realize approximately \$250,000 in tax savings. In addition, this firm regularly undertook bridge design projects, so once it was established how this project met the four-part test, the firm had a model from which to claim the credit on other bridge projects.

Taking full advantage of R&D tax credits

Another client of ours was a nationwide engineering service firm that provides a variety of structural, geotechnical, civil, and environmental engineering services. This firm did not understand that it regularly conducted qualified research activity, and in fact, had sought the assistance of a large international accounting firm for several years to claim available federal and state R&D tax credits. Although the large accounting firm was knowledgeable in the relevant laws and regulations, it lacked the industry expertise to understand fully the engineering firm's projects, job costing system, and engineering documentation. As a result, it did not have the requisite competence to understand fully and assess the thousands of

projects that the engineering service firm conducted during the course of a year. The result was a dramatic under-utilization of the credit that left a great deal of money on the table.

Specifically, because of the accounting firm's inexperience, only a handful of the larger foundation and structural design projects were qualified for the credit, when in fact a large number of smaller projects also included qualifying research activities. Once we had assessed all of the projects this firm engaged in, it was able to achieve federal and state tax savings in excess of \$1 million.

The point of this illustration is simple: While CPA firms may well understand all the relevant tax law and regulations, very few have the in-house technical expertise in any specific field to properly qualify and quantify the R&D tax credit. Conversely, while engineering firms know their own business better than anyone, they don't have the tax expertise to know how to claim the credit successfully. Not only are laws and regulations involved, but also case law from tax court and other venues. Like engineering projects, it's a complex process that must be completed accurately. For these reasons, outside firms, such as *alliantgroup*, with extensive expertise and experience in both tax law and the engineering disciplines, are generally called in either by the engineering firm or its CPA.

With the current economy, it is ever more important for businesses to seek all available tax credits and incentives, and with more than 7,000 federal and state tax credits and incentives available, it simply doesn't make sense to leave the cash lying in a drawer.

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