The R&D Tax Credit – It's Not Just for High-Tech Companies!

by Justin Goodson & Steffanie Gunn[1]

Introduction

The United States Federal Credit for Increasing Research Activities and the Canadian Scientific Research and Experimental Development Tax Incentive Program, or SRED, (both hereinafter referred to as "R&D credit" or "R&D credits") are tax incentives often overlooked by many qualifying companies. Typically, when people hear the phrase "research and development," they immediately think their company does not qualify for this credit and that the credit is reserved for bellwether companies or organizations such as Microsoft, Boeing, Intel, Lockheed Martin, Merck, Pfizer, etc. This assumption is, in fact, wrong. When compared to the "traditional" definition of R&D, the tax definition of "research and development" is quite broad in terms of the types of activities and costs that qualify for these powerful government-sponsored tax incentives. In the ensuing paragraphs, we will discuss what types of companies, activities and costs qualify for the R&D credit and, hopefully, you will be able to determine whether your company is a good candidate for the United States R&D Credit or the Canadian SRED Credit.

Background of the R&D Credit

United States:

The legislation establishing the R&D tax credit was first enacted in 1981. Since then, it has been revised, amended and extended by Congress several times with the consistent intention of improving and strengthening its benefits in order to keep domestic companies competitive with their international counterparts. In addition, many states have followed in the footsteps of Congress and enacted similar legislation providing state R&D tax incentives.

The R&D credit is meant to encourage the growth and development of businesses throughout the nation and, as such, it was the intent of Congress, the Internal Revenue Service ("IRS"), and the current Administration to allow for the credit to apply to a wider range of companies and activities in order to strengthen domestic corporate investment. To this end, Congress and the current Administration recently relaxed the rules governing the R&D tax credit in an effort to increase its applicability to a wider range of companies and activities because, over the past two decades, the United States has been losing valuable resources in manufacturing and R&D to other competing countries. Furthermore, if this downward trend were to continue, the United States would be in danger of becoming the world's largest "middleman" as valuable intellectual resources and human capital opted to work and stay offshore, as opposed to residing in the United States. This migration of resources and talent offshore is a primary reason why the current Administration, Congress and the IRS have relaxed the rules governing the R&D tax credit and it is these changes in the rules that may allow your company to qualify for the R&D credit.

Canada:

Under this program, any individual or corporation carrying on qualified research in Canada is eligible for tax incentives - even a corporation that is controlled or owned by a U.S. parent may be eligible. The SRED program is Canada's largest single source of federal government support for industrial research and development. In addition to the federal incentive program, several provinces and territories within Canada have their own complementary programs, many of which are administered by the Canadian Revenue Agency ("CRA"). As in the United States, the primary objective of these programs is to keep Canadian businesses competitive by spurring innovation through research and development.

What types of companies are good candidates for the R&D credit?

As evidenced by the title of this chapter, the R&D credit is not only for high-tech, biotechnology and software companies. Some of the best candidates for the R&D credit are found in the following industries: manufacturing, tool and die, agriculture, software development, biotechnology, structural engineering, food processing, and pharmaceutical, amongst others. If your company has invested time, labor and funds toward the advancement of its products, processes, formulas, inventions or techniques, then it may qualify for the R&D credit. If your company is in one of the industries listed above, please read on as you may qualify for these powerful government tax incentives.

What qualifies as "research and development" for tax purposes?

United States:

The Internal Revenue Code ("IRC") defines qualified research as *activities performed to discover knowledge that is technological in nature for the development or improvement of a business component used for a permitted purpose in conducting a trade or business*. What does that mean? It means that designing, developing or improving a new product; developing or improving a manufacturing process or other business process; determining a formulation; programming a new software application; or developing an invention to be patented (regardless of whether it succeeds or fails), for your business are all potential qualifying projects or activities with regard to the R&D tax credit.

Specifically, to qualify for the R&D credit, the qualifying activities performed must meet four qualifications: 1) the activity must be related to the development or improvement of a business component (product, process, formula, invention, software or technique) 2) there must be some uncertainty as to the method, capability or design of the business component, 3) there must be a process of experimentation to overcome the uncertainty, and 4) the activities must relate to one of the "hard sciences" (e.g. engineering, chemistry, physics, biology, biotechnology, computer science, etc).

Canada:

The term "SR&ED" is defined in the Canadian federal Income Tax Act ("ITA") to mean *a systematic investigation or search that is carried out in a field of science or technology by means of experiment or analysis.* Under the SRED program, three types of research categories are eligible for SR&ED benefits: 1) basic research – work performed for the advancement of knowledge and science without any practical application in mind; 2) applied research – work carried out for the advancement of science with a specific application in mind; and 3) experimental development – work undertaken to achieve a technological advancement in order to create, or improve materials, products, or processes. The majority of SR&ED claims fall into this latter category – experimental development.

In order for a company to qualify an activity or project as experimental development for SR&ED purposes, three criteria must be met: 1) there must be some type of technological advancement sought by the project or activity undertaken, 2) there must be some type of technological uncertainty at the outset of the project or activity, 3) a systematic investigation must be utilized towards eliminating the technical uncertainty present.

* * *

The activities that can qualify for the R&D credit can be large-scale business developments or small-scale process improvements. The scope of the project is immaterial, as long as the activities relate to the advancement of the underlying business. The startup of a new business or a new division often involves a significant amount of qualifying activities. For example, in many cases, the entire business process must be developed, tested, evaluated and modified until it is operating smoothly. In addition, the testing of an alternative raw material for potential cost savings or the alteration of a process in an effort to reduce lost product, increase throughput, and maximize overall efficiency may also qualify for the R&D credit

Oftentimes, the normal day-to-day activities which company personnel conduct may qualify for the R&D credit. For example, the systematic trial-and-error process and associated testing and redesign work which is often employed during the development or improvement of a product design is often taken for granted as just "getting the job done." While these activities may seem routine, they constitute a process of experimentation that is undertaken to "get the job done" and may, in fact, qualify for the R&D credit. Furthermore, success is not a requirement in order for a company to claim the R&D credit for a particular project or activity. The nature of the qualifying activities and the intent of the project to advance the underlying business are sufficient to claim the R&D credit.

<u>What types of costs qualify for the R&D credit?</u>

The expenditures that may be applied toward the R&D credit include both in-house research expenses as well as contract research expenses. The in-house research expenses that can qualify for the R&D credit fall into two categories: 1) wages paid to company

employees for conducting, directly supporting and directly supervising qualified R&D activities (as described in the preceding section) and 2) the cost of supplies used or consumed in relation to these R&D activities. Additionally, some capital costs associated with the SRED credit may also be eligible for Canadian companies. Contract research expenses are those amounts paid to anyone outside the company performing qualifying research activities on your company's behalf. The time and effort devoted to conducting research does not necessarily have to be undertaken by your employees. By contracting with outside individuals or companies to conduct these activities on your behalf, provided their contract expenses qualify for the R&D credit (see preceding section), you are improving and advancing your company and, as such, those expenditures may qualify for the R&D credit.

Benefits of the R&D Credit

United States:

In general, claiming the R&D tax credit results in a net cash benefit of 6.5% of "qualified research expenditures." Thus, in general, for every $100,000 of identified qualified research expenditures, the company will typically receive $6,500 of R&D tax credit. However, this net benefit calculation is subject to certain limitations which you can discuss with a qualified R&D tax credit service provider.

Canada:

Companies that have qualifying research and development activities are entitled to either a 35% or 20% investment tax credit. A qualifying Canadian Controlled Private Corporation ("CCPC") is given preferential treatment at an enhanced rate of 35%, subject to certain limitations. If a company is a qualifying CCPC, the first $2 million of its expenditures are subject to the 35% rate and may be completely refundable. This means a CCPC operating at a loss may still be entitled to a refund even though it has paid no taxes in the year. On the other end of the spectrum is a non-CCPC which is entitled to a non-refundable 20% credit on its qualifying research expenditures.

* * *

The R&D credis offers a greater financial return than simply deducting or capitalizing the costs of the research activities. The R&D credit is a "dollar-for-dollar" reduction of a company's tax liability (as illustrated in the above example). Furthermore, if there are any excess credits available – i.e. excess credits after any refund amounts are received – these credits can be carried forward for up to twenty years in the United States and ten years in Canada, providing financial benefits for today's activities for years to come.

Lastly, claiming the R&D credit potentially creates a vehicle by which to realize additional tax savings in the future. It can lower your company's overall effective tax rate as well as increases the market value and earning power of your company. The R&D

tax credit provides a return on your investment in ideas and concepts which are new to your company, thereby encouraging future investments.

Companies that elect not to claim the R&D credit may be declining revenue that they have rightfully earned. Such companies may find themselves at a significant disadvantage in the competitive business world.

Conclusion

The United States and Canada offer some of the world's richest R&D tax incentives, but, chances are, companies are not taking advantage of them to get the cash they deserve. As the pace of business accelerates and competition increases, small to mid-size companies may be more likely to overlook this source of cash because many lack the time, resources or expertise needed to identify and manage SR&ED tax credit claims.

Both the United States and Canadian governments have intentionally broadened the scope of the businesses which may benefit from the R&D credit in order to stimulate the economy and reward those companies who undertake activities to make their chosen field more efficient and innovative. Companies continually participate in these activities simply to remain competitive, without realizing their daily operations may also entitle them to tens of thousands of dollars in tax incentives. If your company is in any one of the industries described above, you may be a candidate for this powerful government tax incentive.

Who is alliantgroup?[2]

alliantgroup is an independent, international professional services firm focused on delivering government-sponsored tax incentives, primarily the R&D tax credit, to middle-market companies in a variety of industries. alliantgroup focuses not only on the quantitative side – i.e. calculating tax credits based on the qualified wage, supply and outsourced contract research expenditures (as described above) – but also on the qualitative side, including preparing and delivering a detailed written R&D study that serves as your company's documentation supporting the R&D tax credit claimed. If you feel that some of your company's activities may qualify for the R&D credit, please visit www.alliantgroup.com for further information.

How do I determine if my company qualifies for the U.S. or Canadian R&D Credit? Ask yourself the following questions:

1. Do any of my company's activities meet the qualifications for the U.S. or Canadian tax credit?
2. Does my company design, develop or manufacture new and / or existing products?
3. Does my company attempt to improve its existing products or formulas or find new ways to use or manufacture those products or formulas?

4. Does my company look for ways to improve its internal processes or techniques?
5. Does my company develop inventions or obtain patents?
6. Does my company develop or engineer software applications?
7. Is my company in one of the industries listed above?

If the answer to any of the above questions is yes, you may be a great candidate for the R&D tax credit. If so, go to the next section to identify what documentation and information you will need.

Questions to Ask Your Accountant / R&D Credit Advisor

For all business entities related or commonly owned with your company, ask the following questions:

1. Am I taking the R&D credit?
2. For all open tax years, what is the amount of regular tax and tentative minimum tax I am paying?
3. Am I in a Net Operating Loss or Alternative Minimum Tax position?
4. What state taxes do I pay?

1. Justin Goodson is an Associate Director in the Houston office of alliantgroup, and Steffanie Gunn is a National Director in the Orange County office of alliantgroup.
2. www.alliantgroup.com; Phone 800-564-4540