

# The Illinois Manufacturer

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## Workers' Compensation Reform

### *Also in this issue*

- **Make sure your company reaps all the benefits from new R&D tax credits**
- **An important ruling could protect Illinois businesses from consumer fraud lawsuit abuse**
- **IMA member testifies before National Science Board on the skills gap**
- **IMA-led Illinois Coalition holds its first Annual Meeting**

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# Benefit from new R&D tax credits

Most manufacturers are not aware that federal and state research and development tax-credit programs exist that may reward their day-to-day efforts aimed at producing a more efficient product. The Research and Development Tax Credit is a government-sponsored benefit that provides cash incentives for companies conducting R&D in the United States. These economic incentives are conservative, government-sponsored programs backed by the Internal Revenue Service, Congress and the current Administration in order to stimulate research and development in industries of all size, and to provide an avenue of encouragement for companies to work together and transform the economic landscape. Over \$5 billion in federal R&D tax credit benefits are given out annually.

The impetus behind mid-sized and

smaller companies' ability to qualify for the credits has been the recent changes to the IRS regulations. The R&D Credit has existed since 1981; however, prior to December 2001, the requirements necessary to qualify for the R&D tax credit were rather difficult to attain. In December 2001, the Bush administration issued proposed IRS regulations that apply retroactively, and have made it significantly easier to qualify for the R&D Tax Credit. Specifically, the new regulations have relaxed the documentation required to support the credit, and eliminated the discovery test.

In January 2004, the IRS ratified these regulations for the Research and Development Tax Credit. These final regulations have now opened the door for eligible taxpayers to "look back" for potential refund claims for credits for which the taxpayer was unaware.

The new regulations coincide with the intent of Congress, are much more taxpayer friendly and reflect a profound change in the position of the IRS.

The new regulations:

- 1) Make it easier for a broader array of companies to qualify their activities as R&D; and
- 2) provide

flexibility in certain recordkeeping requirements.

## Redefining research and development

Many taxpayers tend to regard R&D as an activity associated solely with high-tech, biotech and pharmaceutical-type companies. Prior to the relaxed regulations, there was some truth to this perspective. The former regulations required that the company obtain knowledge that exceeds, expands or refines

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The taxpayer must now develop a new or improved business component that is based with technology grounded in the physical sciences (that is, engineering principles, biology, chemistry, computer science, etc.) However, with the relaxed regulations finalized and extended by the current administration, the definition of R&D is broader, and in fact, companies in the tooling, mold and die industries are prime candidates for the credit.

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the common knowledge of skilled professionals. This essentially required that the taxpayer develop a product or process that was unique to the world. At present, this requirement has been eliminated since there was no indication that Congress intended

See **R&D**, page 25



## R&D

Cont. from page 10

such interpretation. The taxpayer must now develop a new or improved business component that is based with technology grounded in the physical sciences (that is, engineering principles, biology, chemistry, computer science, etc.) However, with the relaxed regulations finalized and extended by the current administration, the definition of R&D is broader, and in fact, companies in the tooling, mold and die industries are prime candidates for the credit. Furthermore, companies involved in any of the following activities, may also be eligible to claim the R&D tax credit:

- Manufacturer of products
- Develop new, improved, or more reliable products/processes/formulas
- Develop prototypes or models (including computer-generated models)
- Design tools, jigs, molds and dies
- Develop or apply for patents
- Certification testing
- Testing of new concepts and technology
- Development of new technology
- Attempted use of new materials
- Added new equipment
- Environmental testing
- Develop or improve production/manufacturing processes
- Develop, implement or upgrade systems and/or software
- Develop production control software
- Improve or build new manufacturing facilities
- Automate/streamline internal processes
- Expend resources on outside consultants/contractors to do any of the above-stated activities

As the extensive list of qualifying activities illustrate, the new changes afford a broad array of companies to qualify for the research and development credit, however many taxpayers miss out on qualified R&D expenditures in areas such as manufacturing, engineering, quality assurances, marketing, purchasing

and information technology. Many manufacturing companies tend to regard their own efforts to make new, lighter, stronger, cheaper, more-reliable products, or to make more precise, more economical and more versatile processes as “just doing my job,” when in fact they have been performing R&D qualifying activities all along.

### Taking advantage of the R&D Tax Credit

The R&D Tax Credit opportunity can provide, among other things, a hidden and immediate source of cash for many small and mid-size companies, and a significant

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reduction to current and future years’ federal and state tax liabilities.

The R&D Credit is largely based on an allocation of labor costs that are attributable to the aforementioned qualifying activities. Often times, especially in privately owned companies, one’s title is not indicative of whether time is spent on R&D activities, as such individuals who wear many hats. Identifying and documenting the R&D credit can be complex, but the results can be well worth the analysis.

Companies that have qualifying research and development activities are entitled to a 20 percent research tax credit, subject to certain limitations for previous years. The credit offsets taxes owed or paid, dollar for dollar, which is much more powerful than a standard deduction, which only reduces a company’s

taxable income. Further, a business can obtain the credit for all open tax years — generally the last three or four years — plus the current year and additional years may be available if the taxpayer is in a net operating loss or alternative minimum tax position. If the taxpayer is not in a refund opportunity, the tax credits may carry forward for up to 20 years. Additionally, the taxpayer may be able to expense all such costs in the year incurred.

Practically speaking, there is a three-step process to explore this opportunity. First, an evaluation of whether you qualify and a broad determination of credit potential is needed. Second, you’ll need a tax analysis of the ability to use the credits (that is, past, present, future). And third, you must quantify and document the credits and file the amended returns, if necessary.

The U.S. offers some of the world’s richest R&D tax incentives, but chances are companies have not taken advantage of them to get the cash they deserve. As the pace of business accelerates and competition increases, small to mid-size manufacturers may be more likely to overlook this source of cash because many lack the time, resources or expertise needed to identify and manage R&D tax credit claims. The government has intentionally broadened the scope of those businesses which may benefit from the tax credit in order to stimulate the economy and reward those who undertake to make their chosen field more efficient, safe and innovative. Manufacturers continually participate in these activities simply to remain competitive, without realizing that their daily operations may also entitle them to tens of thousands of dollars in tax credits. ■

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