

## R&D tax credits: A strengthened alternative for tax savings

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### Follow these steps to help your firm when filing your returns.

As tax return filing deadlines for 2009 loom in the next few months, prudent business taxpayers, including architecture and engineering firms, should be looking for all available tax deductions and credits to reduce federal and state tax liabilities. One of the most powerful tax incentives available are federal and state research and development (R&D) tax credits.

Most design service firms in the A/E industry are unaware that they qualify for R&D tax credits and that these dollar-for-dollar reducers of tax liability often rise to significant amounts in a given tax year. Even the design firms that recognize the R&D tax credits' applicability to their activities may not be aware that for tax years ending in 2009 a strengthened federal alternative credit calculation is available to them at their election.

### How do R&D tax credits apply to A/E firms?

Federal and many state governments offer tax credits for R&D activities. Despite traditional notions and dictionary definitions, there is no tax code requirement that qualified R&D activity is only for the development of revolutionary or patentable inventions that advance a given industry. To the contrary, a main requirement of qualified R&D as codified in Section 41 of the Internal Revenue Code (IRC) is for the development or improvement of a "business component." It is true that one type of business component is an invention; however, business components also include products, processes, techniques, formulas, and computer software. Furthermore, this development or improvement is relative to the taxpayer and not the industry as a whole.

Of course, there are other IRC criteria to consider before an activity or project qualifies as R&D. Specifically, the project is required to be undertaken to discover information that is "technological in nature" and to eliminate "uncertainty." Furthermore, the activity needs to constitute a "process of experimentation." The applicable Treasury regulations and other guidance provide further explanations of

these tests. Specifically, a project meets the "technological in nature" requirement to the extent that the activity fundamentally relies upon engineering, physics, chemistry, biology, or computer science. Additionally, a taxpayer's project will satisfy the "uncertainty" test if uncertainty exists with the business component's capability, method, or design. Finally, an activity constitutes a "process of experimentation" if it is a process designed to evaluate one or more design alternatives.

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As an example, let's consider a project to design a commercial office building. The players in this project include an architecture firm that is contracted to design the building, and an engineering firm hired to develop the foundations, structures, and the mechanical, electrical, and plumbing systems. The firms both have extensive experience in designing and developing similar buildings and systems, and their technical staff would consider this project "routine." However, the project is unique to specific requirements, including the municipal codes for energy usage and structure along with the unique characteristics to the project site and numerous other attributes. Despite similar projects in the past, the firms cannot adapt existing designs to meet the project requirements. To meet all goals, the design team needs to employ modeling tools, engineering and architecture assessments, and technical expertise to evaluate the criteria and assess alternatives that will reach an appropriate design for the project.

In this simplified example, the architects' and engineers' activities associated with the technical design evaluations to overcome the design uncertainty of this building development would likely qualify for R&D tax credits.

### How much are the R&D tax credits and what is new for tax years ended in 2009?

For federal purposes, a taxpayer can claim R&D tax credits on original filed tax returns or amended prior year tax returns for cash refunds within a three-year statute of limitations. Since the R&D tax credit is for activities, it is computed based on the expenses associated with qualified R&D, most notably in-house wage expenses. The primary method of computing the tax credit can reach a maximum potential of 6.5% of the total qualifying research expenses. For an A/E firm with significant design activities, this can add up to significant tax savings over a four-year period.

However, this primary method of credit computation is subject to a base amount, which may reduce this 6.5% maximum credit potential. Recognizing the limitations that may be experienced by taxpayers, Congress recently introduced an alternative method of credit calculation. This "Alternative Simplified Credit" allows a taxpayer to claim a net R&D tax credit for tax years ending in 2009 equal to 9% of the qualified R&D expenses that exceed half the average of the prior three years' qualified research expenses.

For year-end taxpayers, 2009 tax return filing deadlines and 2006 federal statute of limitations deadlines to amend for tax refunds are right around the corner. Therefore, it is important for principals and officers of A/E firms to understand all available tax incentives entitled to them. Although the consultation of their tax accountants is a must, the assistance of specialty tax service providers with a unique combination of engineering, scientific, legal, and accounting expertise is critical in establishing the maximum supportable credit claims entitled to them by law. ■

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