

R&D credit: it's not just for laboratories anymore

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Although the definition of the research and development credit has expanded to include a wide variety of industries since it was first instituted in the 1980s, many businesses still think that this lucrative tax benefit is only for the white lab coat set—much to their detriment, according to a speaker at the FAE's May 1 Apparel & Textile Breakfast Conference.

Sonny Grover, senior managing director and executive vice president at alliantgroup in New York, said that many business clients assume that “R&D is just for lab coats, or R&D is just for pharmaceuticals.” Part of this, he said, comes from the history behind the R&D credit, which at first was greatly concerned with the hard sciences and technological development when it came into being during the Reagan administration.

“When I started my career in R&D studies in the '80s, it was almost always for the pharmaceutical industry, for the deep sciences. I would never be sitting in front of a group that [involved] apparel,” he said.

The reason for the credit's original focus, he said, was Congress' desire for dynamic companies to invest the money they'd save into new research activities that could lead to exciting scientific discoveries in order to spur economic development. With this in mind, companies that wanted the credit needed documentation showing that they were engaged in a qualifying research activity that had qualifying research expenses; at the time, this meant work conducted in a laboratory.

“When they put the credit in place under Reagan,” he said, “they didn't want you to take the money and put it in your pocket, they want you to innovate.”

Around the same time the Cold War ended, Grover said, attitudes about the R&D tax credit began to change. Experts cited emerging problems in the way the credit was structured, a shift partially influenced by the changes the U.S. economy encountered in the 1990s.

Many businesses, he said, began outsourcing much of the engineering work, design work and other activities financed by the credit, and Congress subsidizing overseas activities. There was also the fact, he said, that approximately \$5 billion in these credits were claimed mainly by the Fortune Top 1000 companies, while the majority of the U.S. gross domestic product is driven by small to mid-sized businesses. Part of the reason for this, too, was that the standards for the credit were difficult to meet, which kept out smaller businesses, he said.

“Congress's focus was ‘How do we innovate the small- to mid-sized business level?’” he said. “If we can't innovate at this level and hire at this level, we may as well forget it.”

While Congress still wanted companies to innovate, lawmakers began to realize that innovation didn't necessarily have to come from a laboratory. With this in mind, Grover said that the focus for the R&D credit shifted from activities geared toward producing scientific discoveries that are new to the world, to business-scale innovation and created "a product, process, technique or design, stronger, better lighter, cheaper, faster and so on."

The changes came gradually over the last few years, with Congress legislating various changes to change how the credit worked. In 2004, he said, the discovery requirements were eliminated and the documentation requirements were relaxed. The year 2007 saw the introduction of the alternative simplified credit, which was increased from 12 percent to 14 percent in 2008. Finally, he said, 2010 saw the passage of the Small Business Jobs Act, which addressed many of the lingering problems with the credit as it pertained to the alternative minimum tax — generally, the alternative minimum tax would cancel out the benefits of the R&D credit. The act, he said, effectively turned [the AMT] off for companies with less than \$50 million of average sales a year.

"This is like the Holy Grail of R&D for us," Grover said, "because there are so many people who can take advantage." Today, he said, in order for an activity to qualify for the credit, it must involve a new or improved business component, be technological in nature, eliminate uncertainty, and involve a process of experimentation. These criteria could be applied to a product, a process, a technique or design, a formulation, an invention and to software.

Because of these changes, apparel and textile businesses can take advantage of the credit, he said, and brought up several case studies. One company, for example, was able to use the credit because they were improving leather jackets through developing new leather finishing treatments, rain-resistance technology and increased breathability, which resulted in a \$203,000 credit. Another, he said, involved a shoe company that developed a patented comfort cushion for a new line of shoes and improved its manufacturing process and developed perspiration-absorbent material. A third, a jewelry company, was able to qualify by developing improved soldering, casing and molding techniques, as well as developing a new silver-finishing product.

Despite the expansion over the years in the applicability of the R&D credit, he pointed out that it's still one of the more restrictive ones in the world. Canada, for example, has a refundable credit (in the U.S., it is nonrefundable) along with help desks to assist companies to claim it. This is because countries throughout the world are competing for talented researchers for their labor force.

The Small Business Jobs Act AMT fix only applies to the 2010 tax year, though the credits carry back five years. As a result, businesses can still use them even if they ran a loss that year, and carry forward up to 20 years, he said. However, he added that the credit is very popular, usually being a key part of Congress' tax extender packages, so he was confident that it could be extended.

"So we can very much expect ... that the credit will be extended," he said, adding a caveat: "We don't think it will happen until [after] the election."

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