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FOUR REASONS CONTRACT MANUFACTURERS SHOULD BE CLAIMING THE R&D TAX CREDIT

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For contract manufacturers, especially those working with metals or plastics, now is the time to explore a potentially highly profitable opportunity: the Research and Development (R&D) Tax Credit. Producing an estimated \$10 billion in annual tax savings for U.S. companies, the R&D Tax Credit remains the quickest avenue for many businesses to accelerate their growth—and due to several key factors, contract manufacturers are among the greatest candidates for what can be significant federal and state tax savings.

How do I know this? Because I've seen firsthand how valuable the credit can be in generating added value for this specific niche industry, with contract manufacturers time and time again being handsomely rewarded for many of their daily activities. Case in point—**one contract manufacturer specializing in metal stamping and precision metal products received \$433,052 in federal and state tax credits for four years' worth of projects.**

Why was this company so successful in their pursuit of the credit? Generally, contract manufacturers can see high-end results for four specific reasons—and if one or more of the following apply to your business, the R&D credit could very likely improve your company's bottom line.

1. Your Company Improves a Product

For manufacturers (contract or otherwise), this is a common path toward eligibility. Indeed, having worked with all sorts of manufacturers, I can tell you that there is a tendency among these companies to think of “research and development” as only being relevant to the kind of work taking place at a medical research facility or within the halls of a Silicon Valley startup.

This, however, could not be further from the truth. When it comes to the world of tax and the R&D credit, applied sciences count just as much toward eligibility. The everyday technical problem-solving performed by manufacturers to simply improve an existing product, the steps taken on the factory floor to solve a production issue to make that product, or the trial-and-error performed to ensure that the product meets a client's specifications are generally what put manufacturers (especially contract manufacturers) on the road to tax savings.

Bringing this back to the real-world, let's take a look at a qualifying project completed by the metal stamper we mentioned before. One customer challenged this stamper to manufacture a metal building roof clip designed for high wind applications. While developing the proposed part for the customer, the company evaluated several alternative methods of machining, such as utilizing a CNC punch press or a CNC mill to create a roof clip with the strength and tolerance required to survive high winds. For better machining accuracy, the company settled on using a punch press to machine the holes in the designed part and developed an initial press brake program iteration, performing a trial run to prototype the part. To achieve optimal punch positioning, the company improved upon the program delay and trigger timing to meet component specifications.

Technical problem solving through hours of labor, experimentation and multiple test runs—this is how manufacturers (especially contract manufacturers) can become excellent candidates for the R&D Tax Credit.

2. Your Company Invests in Supplies to Improve that Product

Within the manufacturing sector as a whole (which, according

to the most recent numbers released by the IRS, constitutes 61% of total R&D dollars claimed) contract manufacturers tend to achieve some of the highest individual results not just because of the products they are making, but because of the supplies that are needed to create said products.

It all relates back to how the credit is calculated. As discussed earlier, the R&D Tax Credit is an activities-based credit, meaning the technical work to improve products and the processes that make those products are what lead to eligibility. When it comes to calculating an individual credit result, this will ultimately be impacted by **a)** the supplies consumed/used during your R&D-based activities and **b)** the wages of the workers performing those projects.

For contract manufacturers, supply costs may be the most important factor toward driving a meaningful R&D Tax Credit result. Indeed, companies that specialize in forming customized plastic or metal parts (be they plastic injection molders, thermoformers, metal stampers, extruders, fabricators, tool and die shops, etc.) require the use of many supplies during their R&D-based activities. **All of the tools, dies, jigs, fixtures, prototypes and other products used to make a specialized part or one-off for a client—they are all supplies consumed during the R&D process and should be considered as being potentially eligible for R&D treatment.** And, there is now even further reason to sing the praises of supply costs as recent case law and Treasury regulations have further expanded a taxpayer's ability to include such costs toward their R&D Tax Credit calculation.

Case in point—a major contributor to the aforementioned metal stamper's \$400,000 plus in federal and state tax savings was due to the creation of several dies to make their customized parts, including experimenting with several alternative dies to achieve the desired cut dimensions and edge finish for the customized roof clip discussed earlier. The creation of those dies and their role in the metal stamping process also touches on our next path to eligibility.

3. Your Company is Improving the Processes That Make Those Products

Process improvement efforts are, at the same time, the most significant and the most often missed R&D-eligible activities.

Going back to our metal stamper and the customized roof clip, one of the activities that led to qualification was an enhancement made to the production process, specifically to the process of stamping the part. When evaluating the dies discussed earlier, the company did so by assessing the deformity each of the dies caused in the part, noting that

the cold work deformities increased the brittleness of the component (a result of excessive cold work from the dies). To solve this issue, the company mounted an air cylinder to the die to increase the retraction force and minimize cold work induced deformity.

The key takeaway here: when claiming the R&D credit, make sure that you're taking into account all of the activities that are completed during the life cycle of the project (from ideation, to design, to production) that can qualify. Due to some major legislative changes that have opened up the credit (more on that below), it could lead to significant savings for your company.

4. New Laws (Starting in 2016) Have Made Your Company Eligible for the Credit

Our first three points illustrate that the nature of custom manufacturing work is generally what makes these companies an excellent match for the R&D Tax Credit. Now, due to new legislation, the federal government has taken action to ensure all qualifying companies, no matter their size, will be able to take advantage of the credit.

Why? This past December, as a result of the Protecting Americans from Tax Hikes (PATH) Act being signed into law, not only was the R&D Tax Credit made permanent, but the greatest barrier preventing perfectly eligible companies from claiming the credit is now gone. With the removal of the alternative minimum tax (AMT) floor beginning in 2016 for "eligible small businesses" (defined by the legislation as businesses with less than \$50 million in average gross receipts for the prior three years), Congress has provided a pathway for companies whose activities would have qualified for the credit, but were barred due to the AMT floor, to be able to reap the credit's financial rewards. The removal of the AMT floor is anticipated to allow for a tenfold increase in the number of small to mid-sized businesses that can utilize the R&D Tax Credit.

Taking into account these four points, contract manufacturers looking to add value to their business should definitely consider the R&D Tax Credit—it could very well be the most profitable thing you do for your business this year.



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