

# Taking Credit for Business Research

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Companies that perform research toward new or improved products or processes have an opportunity to reduce their income taxes significantly. Even for companies that are not currently paying income tax, the savings can be carried forward for up to 20 years. Businesses may engage in research without being aware of its tax benefits.

However, the requirements for claiming the credit come with complexity. It takes knowledge to identify and measure activities that qualify. The complexity varies with individual needs, but is manageable with the help of a professional having the right expertise. In the end, the benefits can well outweigh the costs.

The tax credit for increasing research activities has the backing of the current Presidential administration. Proposals have been made to make the credit, previously subject to periodic renewal, become permanent. The rate of tax savings for the Alternative Simplified Credit ("ASC"), first introduced in 2007, was increased for 2009 from 12% to 14%. Finally, the ASC is proposed to completely replace the former, more complex, credit calculation by 2011.

**WHAT QUALIFIES FOR THE CREDIT, AND WHAT DOESN'T?** The definition of qualifying research has broadened over time, opening up new possibilities for tax benefits. The credit for increasing research activities has a long history. Congress first provided this incentive during the 1980's, in acknowledging that free markets by themselves did not optimize research spending, because of the risks involved with innovation. However, for many years research was narrowly interpreted as what was new to the scientific community. With the issuance of the U.S. Treasury Department's final regulations in 2003, the definition expanded into what was new to the taxpayer.

Companies that are interested in claiming the credit for increasing research activities must begin by compiling a list of projects that may qualify. Simply put, qualified research consists of a technological project, relating to a new or improved product or process. It starts with a concept that is uncertain as to its final form. It involves choices among alternatives that are pursued through experimentation. Experimentation is characterized by trial and error, through the creation of prototypes, test runs, simulation, or modeling. When the initial uncertainty is resolved, the research is considered ended.

The regulations break down the criteria for qualification into a four-part test, summarized in the box at the end of this article. Problems may occur in meeting these tests. Simple adaptation, meaning applying the same knowledge again, does not qualify, nor does trouble-shooting performed on products after production starts. Those claiming the credit must show that activities relate to new or unique challenges.

Another issue is funded research. It matters who retains the rights to the research, and who bears the risks. If a customer funded the research by paying on a time and materials basis, or otherwise assuming the risk of failure, the research does not qualify. The customer would be entitled to take the credit, not the entity conducting the research.

Finally, because it is a U.S. tax credit, the qualifying activities must be performed within the United States. Research done off-shore does not count.

**HOW ARE THE BENEFITS COMPUTED?** Once a taxpayer has established that it has performed qualifying projects, the next step is to isolate the costs relating to these activities. These include payroll, materials, and outside contractors. Relative to payroll, in determining rate of pay, it is acceptable to divide an employee's total compensation, including bonus and compensated absences, over hours worked.

In other ways, unfortunately, the definition of payroll is more restrictive than companies may use in their cost accounting systems. Payroll fringe items, such as payroll taxes, medical insurance, workmen's compensation, retirement plan contributions, and other employee benefits, are all excluded. Normal factory overhead expenses, such as space, are also not allowed. Items that meet tax criteria for capitalization as assets, such as equipment, do not qualify as materials costs. On another note, outside contractor expenses are subject to a 65% limit, to remove their assumed overhead component.

A significant documentation issue involves connecting the costs claimed for the tax credit with specific qualifying projects. Ideally, the costs would be accounted for through a project costing system, which would cover employee time reporting, plus the direct charges of material and contractor costs. In absence of project costing, it is recommended that taxpayers connect the costs with projects as closely as they can. This requirement is not unreasonable, in that if a project claimed for the credit is found not to qualify, there needs to be a way of measuring the effect that removing it has on the tax credit.

After determining costs, the next step is computing the credit. The ASC entails a comparison of current year costs compared to those incurred in the three previous years. First, an average of three years' expenditures is computed, and then multiplied by 50%. If current year expenses are higher, that excess multiplied by 14% gets the credit.

For example, during the past three years, a company spent \$500,000, \$1,000,000, and \$1,500,000 on research, respectively. The average annual spending is \$1,000,000 which, when multiplied by 50%, gives a base amount of \$500,000. If current year expenditures are \$1,500,000, the credit is the excess of \$1,000,000 multiplied by 14%, or \$140,000. This credit amount would be in place of a tax deduction. Alternatively, an election can be made to factor it down by 65%, to \$91,000, in which case both the deduction and the credit are allowed. Aside from the federal benefits just described, most states offer their own tax incentives for spending on research.

As cumbersome as this sounds, previous rules were even more so. They required a comparison of current expenditures to a base amount, which consisted of the average of the four prior years' sales multiplied by ratio of qualifying expenditures to sales during a base period, set as the years 1984 to 1988, for companies that had been around that long.

Companies that failed to claim the credit in the past may be able to amend prior tax filings. Generally, amendments can be made to federal returns filed within the past three years. The period measured includes extensions of filing dates taken, and can be longer when amending state filings.

However, for all of the benefits, owners of flow-through entities must beware of additional restrictions. The credit is limited by alternative minimum tax. Additionally, passive owners must incur an add-back in determining alternative minimum taxable income for research and development costs.

It is critical that companies work with their tax advisors to assure adequate consideration of the unique facts of their situations. The U.S. Internal Revenue Service is active in auditing claims for the credit.

**SUMMARY OF THE FOUR-PART TEST** In order to qualify for a credit against income taxes in the U.S., research must meet each of the following four criteria:

1. Technological in nature, as in manufacturing, engineering, or computer science. The “soft” sciences, such as market research, are excluded.
2. Related to a new or improved product or process. This means that better products as well as better means of producing them qualify.
3. Intended to resolve uncertainty. This does not require a risk of failure, only a choice of alternatives.
4. Documented with a process of experimentation to overcome the uncertainty. This is a critical component in order for an activity to qualify as research.

For more information on the R&D Credit, please contact Bill Wiersema at [bwiersema@millercooper.com](mailto:bwiersema@millercooper.com)

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