

The R&D Tax Credit

Putting tax credits to work for your business.



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What Is The R&D Tax Credit

Why IS It Now Attractive To Small/Mid-Sized Firms?



- Available to firms engaged in creating new or vastly improved products, processes and technologies in the U.S.
- The rules and regulations changed in the early 2000's to provide incentives to small and mid-sized firms so they could maintain competitiveness
- The credit is a Federal one. Most states offer a Credit as well – they use the Federal definitions but may apply different calculation methods.





Qualifying Industries:

- Manufacturers
- All Metal Works
- Robotics
- Plastics
- Furniture
- Jewelry
- Apparel
- Software Developers
- Pharma Companies
- Food Processing
- Life Sciences
- Energy/Green Work



Who Qualifies?

Example: Software Development

How to Qualify (IRC §§ 992; Reg. § 1.992-1)

Corporations must meet “The Four Part Test” to qualify



1. New or Vastly Improved

The product and/or process in question must be something totally new to the company (never made before) or something they have made before but are now vastly improving it (new materials or capabilities)

2. Technological In Nature

The product and/or process in question must involve some component of the hard sciences (Chemistry, Physics, Engineering, Software, etc.).

3. Element of Risk

The effort(s) in question must contain some element of risk – both Financial and the General Risk of Failure

4. Experimentation

There must exist a means to “test” to prove that the element of risk has either been eliminated or exists to the point that the effort can no longer continue.



How is the Credit Calculated?

Alternative Calculation Methodologies

The credit is defined as an “incremental” credit – that is that each year the amount of qualified expenses are measured against a determined base level and the excess over the base is available for credit calculation.

BASE PERIOD %:

- 1980's company or before
- 1990 company up to 2005
- 2005 and after (Start Up Definition)

Regular Calculation Method

ASC – Simplified Method



The Regular Method



- Involves computing a base level (%) established from its early years and applied to revenue averages preceding the year under study. All qualified research expenses in excess of this “hurdle” are considered qualified for credit calculation.
- The qualified research expenses are made up of the following:
 - Wages
 - Supplies
 - Contractors
- The above calculated wages and supplies expenses count at 100% of determination. All counted contractor expenses count at 65% of invoiced value(s).

The Simplified Method



For companies that do not have sufficient supporting data from those early years to properly support a Base Level computation the “Simplified” method can be utilized. It can only be used to calculate the credit for the current year to be filed – not for going back – but it does usually enable a larger calculation.

- Determine the Qualified Research Expenses (QRE’s) for the three (3) years prior to the year in study. Average it and divide in half.
- Determine the Qualified Research expenses for the current year.
- Subtract the $\frac{1}{2}$ of average of prior years from the current year QRE’s and the remaining total is subject to the credit calculation.

Credit Calculation - Regular Method



- Assume that the following numbers were the results of the study preparation for a year in study: Base Period % was established at 2.5% and current revenues are at \$10 million annual – creating a base increment of \$250,000

○ WAGE QRE'S:	\$700,000
○ SUPPLIES QRE'S:	\$ 150,000
○ CONTRACTOR QRE'S	\$ 100,000

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TOTAL QRE'S	\$ 950,000
LESS: BASE INCREMENT	\$ 250,000
REMAINING QRE'S	\$700,000

GROSS CREDIT: \$ 140,000 (20%)

NET CREDIT: \$ 91,000 (13%)

The above numbers represent the Federal Credit. State Credits, if applicable would be on top of the above amounts.

Credit Calculation – Simplified Method

	2007	2008	2009
○ WAGE QRE'S:	\$350,000	\$450,000	\$550,000
○ SUPPLIES QRE'S:	\$ 30,000	\$ 60,000	\$ 90,000
○ CONTRACTOR QRE'S:	\$ 25,000	\$ 50,000	\$ 75,000
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TOTAL QRE'S	\$405,000	\$560,000	\$715,000
3 YEAR TOTAL:	\$ 1,680,000		
3 YR. AVERAGE:	\$ 560,000		
½ OF AVERAGE:	\$ 280,000		
CURRENT YEAR QRE:	\$ 950,000	[From Prior Slide]	
LESS ½ AVERAGE:	\$ 280,000	-	
NET QRE'S:	\$ 670,000		
GROSS CREDIT:	\$ 134,000	(29%)	
NET CREDIT:	\$ 87,100	(13%)	



Methodology



- **People Who Count**
- **Projects That Count**
- **Allocating People and Time To Projects**
- **Staying Current With Court Cases and Regulation Changes**

Audit Triggers



An audit does not mean that something is wrong – all it means is that the governing body (IRS or FTB) has questions. Other than a random general audit that is a look into everything – an audit of the R&D claim can usually (but not only) be triggered by one of the following:

- A Typical Industry
- Extremely High Credit Claim in Relation to Annual Revenues
- Amendments to Prior Years Returns with High Value Refunds

The major areas of concern when an audit takes place are the following:

- Base Period Calculations
- Wage Allocations: Time to Various Projects

IRS: SUPER IDR'S

Agency Positions – I.R.S.



- **I.R.S.**
 - They have knowledgeable personnel who can evaluate
 - Tend to pay first (to avoid interest accumulation) and audit later – if they want to
 - Super IDR approach is way to check without committing to much in resources
 - Agents can differ in interpretation of rulings – that is why it is important to stay current with all court cases and regulation definitions.

Agency Positions – FTB



- **FTB (FRANCHISE TAX BOARD)**
 - Will use audit as delaying tactic – more to delay and minimize payout by hoping to reach settlement for less on the dollar.
 - Delays tend to increase amounts of interest they owe.
 - States do not have the skilled engineers and others who know R&D. They tend to ask for more data than is necessary. Use vendors who provide audit defense and have solid track record in this area – they can defer wasted time by dealing directly with agents.

There is not guarantee of any automatic audit – nor is there any guarantee that one will not be audited. R&D audits tend to stay focused on the R&D activity only but the taxing authority can – if they wish – pull in other data if they choose (unless you were audited on those areas within the recent years).

Summary



The IRS and FTB has paid out billions of dollars to qualified companies over the past 7 – 8 years. However, there are many more qualified firms that have left this credit unclaimed. Do not let misinformation or fear of the unknown cause you to leave money on the table – money you can use for continued growth of your business.

Questions will be answered in the order received via our webinar chat and if time allows, we will open the phone line for additional questions by phone. Questions can also be submitted via email; please forward to bmadden@elcamino.edu.

Due to the nature of most questions and the time it would take to respond in detail, we will follow-up with all webinar registrants with typed questions and answers.

Questions & Answers



No Cost Credit Assessment



Please provide the following data:

- Name of Company
- Contact Name
- Contact E-mail and Phone
- Industry
- Web Site
- Year Started In Business
- Type of Entity
- Average Revenues – last 4 years
- Average Payroll Total - last 4 years
- What State or States Is Business Conducted In