

R&D tax credits

How to get a financial boost from the government

With the economy in recession and many companies strapped for cash, there is an opportunity for more companies to increase their cash flow by taking advantage of research and development tax credits.

Times are tough these days and competition is fierce. Many companies, and especially small to midsize businesses, often overlook government benefits such as the research and development (R&D) tax credit that are intended to put cash back in their pocket and help them compete.

“The incentive from the government has always been to encourage growth and development of businesses throughout the country,” says Kerry Defler, CPA, tax partner at Habif, Arogeti & Wynne, LLP.

Smart Business spoke to Defler about how companies can take advantage of the growth opportunities that R&D tax credits provide.

Why don't more companies take advantage of the credit?

The most common reasons are lack of time, resources and expertise to adequately understand the rules and document the R&D activities. Many businesses are afraid of being audited, which places an additional burden on time and resources, not to mention the financial cost of dealing with an audit. These are legitimate concerns, but most of these companies underestimate the cash value of the credits. In some cases, the credit amount can be substantial and companies can amend certain prior year returns to claim credits that were previously missed. This could be a nice windfall for a company struggling in today's economic environment. For flow-through entities such as LLCs and S corporations, the credit flows through to the ultimate owners.

How much are companies leaving on the table?

There are a few different ways of computing the credit and certain limitations that come into play, but a general estimate is 6.5 percent of the qualifying expenditures for the federal credit. For example, a company with \$300,000 of qualifying expenses may qualify for a federal tax credit in the neighborhood of \$20,000. This is a dollar-for-dollar reduction in the company's tax liability in addition to receiving a tax deduction for the expenses. Qualifying expenses include wages paid to internal employees, the cost of supplies consumed in the process and amounts paid to



Kerry Defler, CPA
Tax partner
Habif, Arogeti & Wynne, LLP

outside consultants. In addition to the federal credit, many states offer their own credits as an incentive for companies to perform R&D activities. In some states, the credit can equal as much as 20 percent of the costs.

What types of activities qualify as R&D?

There are certain technical requirements that must be met in order for expenditures to qualify for the credit. There must be a technical uncertainty at the outset of the project as to the method, capability, or design of a business component. In essence, this means you may know where you want to go but not how to get there. To resolve the uncertainty, the company must work through a process of experimentation. This typically involves evaluating alternatives and developing, testing and refining hypotheses in order to determine success or failure. R&D activities must also be technological in nature. This means the activities relate to hard sciences such as engineering, physical, biological or computer science. The final requirement is that the experimentation is related to a new or improved business component such as product, process, formula, software or technique.

KERRY DEFLER, CPA, is a tax partner at Habif, Arogeti & Wynne, LLP, servicing individuals, corporations and partnerships in the manufacturing, distribution, real estate and technology industries. He has extensive experience advising clients in the area of state and local tax issues (SALT) including income/franchise tax, property tax, sales tax, consulting on nexus issues and tax credits. He has consulted with clients regarding recognition of deferred revenue for tax purposes, the generation of research and development tax credits, and the application of the provisions of Financial Accounting Standards (FAS) 109. Kerry also assists many international clients with international taxation issues and with tax filings for foreign subsidiaries of U.S. companies. Reach him at (770) 353-5355 or kerry.defler@hawcpa.com.

What companies are good candidates for claiming the credit?

The credit is not only intended for high-tech or large companies. No project is too big or small. Any company that designs, develops or improves products, processes, techniques, formulas or software may be eligible. Companies developing something to be patented would also qualify. Many businesses already perform R&D in their normal day-to-day activities of improving their business and products. The government has simplified the rules in recent years to enable companies in a wide array of industries to claim the credit. Our firm has recently prepared studies in such industries as manufacturing, telecom, pharmaceutical, software development and apparel.

Does the R&D credit provide other benefits? Could it be beneficial for companies in a loss situation, and not currently paying income tax?

Claiming the R&D credit lowers the overall effective tax rate thereby increasing a company's market value and earning potential. Most businesses in a net operating loss position hope to generate positive income and become taxable at some point in the future. Any federal R&D credits generated and not used can be carried forward for up to 20 years. Some of these companies may end up being acquired by other companies. Unused credits may provide future value for an acquiring company. This can be considered when negotiating the selling price for the business.

R&D credits can provide significant value for qualifying businesses. Companies should not be afraid of pursuing credit claims, but they should ensure that they are represented by an accounting firm with significant experience in the area. This will make the process much more efficient and beneficial. <<

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