



CAN YOU BENEFIT FROM THE R&D TAX CREDIT?



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The Research and Development Tax Credit provides an incentive for manufacturing, distribution and other companies that conduct research and development in the United States. In recent years, the Internal Revenue Service finalized regulations for the R&D tax credit that make it much easier to qualify for this benefit. These final regulations opened the door for eligible taxpayers to “look back” for potential refund claims for credits that were either not taken or were understated. The new regulations make it easier for a broader array of companies to qualify their activities as research and development and provide greater flexibility in certain record-keeping requirements.

So what is research and development? The definition is subjective. Accountants may describe the rules, but engineers decide what qualifies. For instance, companies that attempt to develop a new product or improve a product (e.g. improve quality, application, functionality, etc.) may qualify for the credit. Also, companies that develop or improve processes (e.g. develop a methodology to improve the quality or speed of manufacturing) may also qualify.

You may be eligible for the R&D tax credit if you have:

- ✓ Developed products or processes that are or will be patented
- ✓ Developed a specific application that is treated as a trade secret
- ✓ Developed a new or improved upon a product that advances the state-of-the-art and requires a redesign, simulation, mock-up and/or experimental trial
- ✓ Created process improvements in your operations that have involved the development, integration or prototyping of new or innovative technology
- ✓ Developed or incorporated a new technology in order to catch up to a competitor
- ✓ Attempted to develop a product or process improvement, but eventually abandoned it (the project does not have to be successful to be eligible)
- ✓ Incurred costs in any of the following categories:
 - New equipment developed or purchased
 - Prototypes that were discarded or scrapped
 - Material that was consumed during experiments or tests
 - Parts that were made in order to refine a process
 - Consultants or subcontractors hired
 - Unexpected overruns while trying to satisfy a customer’s requirements
 - Test labs that were contracted

For research and experimental expenditures to qualify for the credit, the research must be undertaken for the purpose of discovering information that is technological in nature, substantially all of the research activities must constitute a process of experimentation, and the experimentation must relate to a permitted purpose. Improvements to existing business components qualify. A business component may be a product, formula, technique, process, invention or software.

Research that is specifically excluded from being qualified research includes: (1) research conducted after the commercial production of the business component; (2) research related to the adaptation of an existing business component to a particular customer's need; (3) research related to the duplication of an existing business component; (4) surveys, studies, etc.; (5) research related to certain internal use software; (6) research conducted outside the United States; (7) research in the social sciences, arts or humanities; and (8) any research funded by a grant, contract or by another person or governmental entity.

Eligible costs for the R&D tax credit include contracted research where you bear the risk, as well as supplies and wages. Supplies are the cost of items consumed in the research process and include prototypes. Often times, especially in privately owned companies, a person's title is not indicative of whether he or she spends time on R&D activities, simply because these individuals might wear many hats. Identifying and documenting the R&D credit can be complex, but the results can be well worth the analysis.

The credit offsets tax, dollar for dollar, which is much more beneficial than a straight deduction. Practically speaking, there are three phases to the credit study process. First, you must perform an evaluation of whether you qualify and determine the potential credit. This would involve meeting with your senior management and engineers to discuss the rules. Your accountant then needs to estimate the base period and determine the current open tax returns. Your accountant and engineer also need to identify the qualified expenses. Then preliminary calculations should be run to determine if going through the full process is cost-effective. Second, do a tax analysis of the ability to utilize the credits (i.e. past, present, future). In the third phase, quantify, document and compute accurate amounts. This involves interviewing engineers to document the tests, gathering contemporaneous documentation and gathering the qualifying costs. And lastly, file amended returns, if necessary. While the R&D tax credit process may seem involved, your manufacturing or distribution company could reap a substantial tax benefit worth thousands of dollars or more if you qualify for the credit.

About the Author

Jane A. Syseskey, CPA, MST, is a Tax Manager in the Monmouth County office of Cowan, Guteski & Co., P.A. With more than 20 years of experience in public accounting, she is a recognized expert in working with manufacturers in various industry sectors. She has served clients ranging from small closely held businesses to consolidated corporations with over \$100-million dollars in annual revenue. Ms. Syseskey has been instrumental in saving manufacturers money by initiating proactive tax planning strategies focused on minimizing her client's tax liability, such as cost-segregation studies, corporate and multistate tax issues (Nexus studies), domestic production deductions, inventory models (LIFO conversions), research and development credits, and 1031 tax-deferred exchanges.

At Cowan, Guteski & Co., our goal is to position your manufacturing and distribution company to take advantage of all legitimate strategies to minimize your tax obligation. Contact Ms. Syseskey, of our Manufacturing and Distribution Services Group, at 732-741-2624 ext. 228 or jsyseskey@cowanguteski.com to discuss your particular situation.

About Cowan, Guteski & Co.

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