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Secret Ingredient For Keeping Food Innovations Fresh - The R&D Tax Credit

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SECRET INGREDIENT FOR KEEPING FOOD INNOVATIONS FRESH – THE R&D TAX CREDIT

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Innovation is a key driver in helping food and beverage companies deliver on strategic goals by getting the right products to market with speed and establishing significant competitive differentiation. Successful food and beverage innovation is essential for companies to achieve sustainable growth and profitability for the long run. The majority of food and beverage executives believe that product innovation or portfolio adjustments to "healthier" trends will be instrumental for revenue growth over the next three years.

While executives acknowledge that achievement of strategic goals will depend largely on product innovation, many companies struggle with effectively delivering on innovation initiatives to meet those goals. Failure rates of new food and beverage products are extremely high. Challenges that food and beverage manufacturers have expressed include:

1. Constantly changing consumer demands and volatile economic conditions.
2. Highly competitive landscape with an abundance of product choices, making it exceedingly difficult to create significant competitive differentiation.
3. Intense price competition through pressure from competitors and private-label brands.
4. Fluctuating commodity prices of crops and raw materials.
5. Formulation of strategic responses to ever-changing regulations.

For many food and beverage manufacturers, a large portion of current revenue comes from products that have been introduced into the product portfolio within the last few years. Therefore, catalyzing successful innovation is critical to the long-term strategy and success of the organization. Companies are increasingly recognizing the importance of taking advantage of available tax credits and incentives as a critical weapon in remaining competitive and harnessing innovation.

This article aims to help food and beverage industry executives and decision makers obtain a better understanding of the research and development (R&D) tax credit and its applicability to this particular industry. The content is geared toward taxpayers involved in qualified research activities who want to minimize tax liabilities.

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Food and beverage research and development: why is it important?

As mentioned previously, one common theme to success in the food and beverage industry is continuous innovation. Keeping products fresh for consumers is not easy in a business where product margins are slim and competitors can quickly copy new ideas. However, for those who get it right, the rewards are sweet. Companies and brands that consistently innovate thrive, compared with those that remain stagnant. Winning food companies use broad platforms to quickly customize products for narrow segments. Those platforms include brand, go-to-market, packaging, and technology platforms. Also, identifying and acting on trends early is critical, as is recognizing when a trend has lost steam and making a swift exit.

R&D is an important competitive factor for food developers and fast-food purveyors' survival. These companies are constantly working to create new or improved products and improve the taste, safety, and nutritional content of their products. Accomplishing these objectives is technically challenging and expensive. Food and beverage companies constantly face rising costs of food inputs, fuel volatility, and regulatory changes while trying to keep their pricing competitive to gain market share. Some of these rising costs stem from R&D strategies to create new products related to food safety, cost reduction, organic/natural products, dietary guidelines, and sustainable resources.

Food manufacturers can address the cost and risk of R&D by leveraging available federal, state, and local tax incentives. Businesses that have not taken advantage of the R&D credit have a huge opportunity for improved financial performance (see Exhibit 7). The credit incentivizes an enormous range of activities for companies of all sizes, including activities that most food and beverage companies engage in regularly. The credit continues to be underused by qualified companies and their business management teams primarily because of a misunderstanding of qualification and documentation requirements for federal and state credits, fear of triggering an IRS audit, and the perception that the credits are limited in scope or fleeting due to their persistent short renewal periods.

Food and beverage companies should look closely at this incentive even if, in the past, they did not believe that their activities in developing new products or processes qualified as technological research. It is often assumed mistakenly that credits apply to only the creation of a new product or package, but food companies can qualify for R&D credits in several ways, including for activities that they already perform.

Introduction: what is the R&D credit?

Congress first enacted the R&D credit, also known as the research and experimentation (R&E) tax credit, in 1981. The credit's purpose is to reward U.S. companies for increasing spending on R&D within the U.S. The R&D credit is available to businesses that create new, improved, or technologically advanced products, processes, principles, methodologies, or materials. In addition to "revolutionary" activities, the credit may be available if the company has performed "evolutionary" activities such as investing time, money, and resources toward improving its products and processes. Correctly calculating the R&D credit is critical because it can lower a company's effective tax rate and increase cash flow.

How does the R&D credit work?

The R&D credit is available to taxpayers who incur incremental expenses for qualified research activities (QRAs) conducted within the U.S.

The credit is comprised primarily of the following qualified research expenses (QREs):

1. Internal wages paid to employees for qualified services.[1]
2. Supplies used and consumed in the R&D process.[2]
3. 65% of fees paid to outside contractors (when someone other than the taxpayer's employees performs a QRA on the taxpayer's behalf, regardless of the success of the research).[3]

[1] Wages include amounts considered wages for federal income tax withholding purposes. Sections 41(b)(2)(D)(i) and 3401(a).

[2] Supplies are any tangible property other than land or improvements to land, and property subject to depreciation. Section 41(b)(2)(C).

[3] Section 41(b)(3).

[4] Section 41(b)(3)(C).

[5] Section 41(d)(1).

[6] Reg. 1.41-2(e)(2).

[7] Reg. 1.41-2(e)(3); *Lockheed Martin Corporation,* 210 F.3d 1366 (CA FC, 2000).

[8] www.irs.gov/Businesses/Audit-Techniques-Guide:-Credit-for-Increasing-Research-Activities-(i.e.-Research-Tax-Credit)-IRC-%C2%A7-41*Table-of-Contents.

[9] *Union Carbide Corporation,* TCM 2009-50.

[10] *Cohan,* 39 F.2d 540 (CA-2, 1930).

4. Basic research payments to qualified educational institutions and various scientific research organizations.[4]

To qualify for the R&D credit, the taxpayer must show that an activity meets four tests[5]:

1. The activity must rely on a hard science, such as engineering, computer science, biological science, or physical science.
2. The activity must relate to the development of new or improved functionality, performance, reliability, or quality features of a structure or component of a structure, including product or process designs that a firm develops for its clients.
3. Technological uncertainty must exist at the outset of the activity, i.e., if the information available at the outset of the project does not establish the capability or methodology for developing or improving the business component, or the appropriate design of the business component.
4. A process of experimentation (e.g., an iterative testing process) must be conducted to eliminate the technological uncertainty. This includes assessing a design through modeling or computational analysis and experimenting with a material's durability or longevity or shelf life of a food product or ingredient.

Once it is established that an activity qualifies, a thorough analysis must be performed to ensure that the taxpayer has assumed the financial risk associated with,[6] and will have substantial rights to,[7] the products or processes that are developed. Next, a method for identifying, quantifying, and documenting project costs that may be eligible for the R&D credit must be created.

Determining the true cost of R&D is often difficult because few companies have a project accounting system that captures many of the supporting costs provided by the various personnel who collaborate on R&D. The typical project tracking system does not include contractor fees, direct support costs, and salaries of high-level personnel who participate in the research effort.

A company may be required to change its recordkeeping process to compile appropriate documentation because the taxpayer bears the burden of proof regarding all claimed R&D expenses. A company must maintain documentation to illustrate a nexus between the QRE and the QRA. According to the IRS Audit Techniques Guide for the R&D credit,[8] the documentation must be contemporaneous, meaning that is was created in the ordinary course of conducting the QRAs. Further, a careful analysis should be done to evaluate whether expenses associated with eligible activities performed in the company outside the R&D department can be included in the R&D credit calculation. This is accomplished by interviewing personnel directly involved in R&D or those who support or supervise R&D efforts.

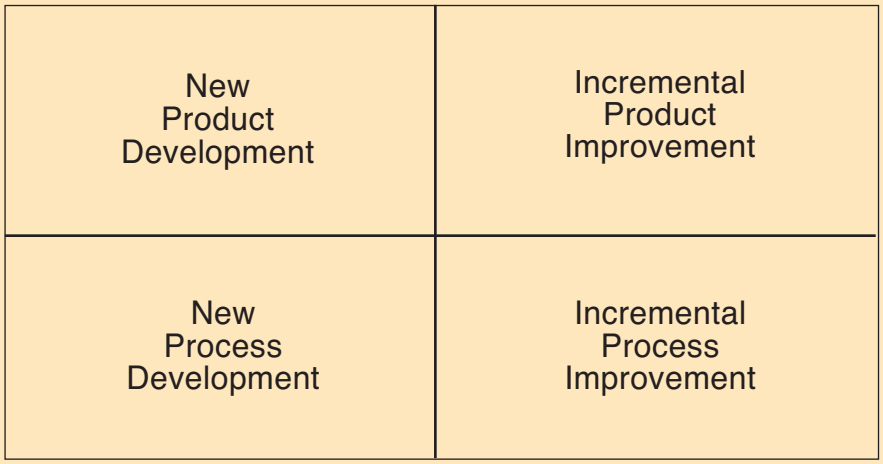
In *Union Carbide,*[9] the Tax Court applied the "Cohan rule" and held that a taxpayer can rely on reasonable estimates when actual expenditures are not available through oral testimony. Specifically, employees could be interviewed to identify completed research projects, the work performed, and the time that each employee spent on the project. This opinion is favorable to taxpayers in its application of the type of evidence needed to support an R&D credit claim. For taxpayers without detailed records, reasonable estimates based on the longstanding rule in *Cohan*[10] may be allowed. However, it is still preferential to always keep contemporaneous documentation in support of research activities.

Recent developments

The R&D credit has been evolving ever since it was originally enacted and enjoys broad bipartisan political support. The American Taxpayer Relief Act of 2012 (P.L. 112-240, 1/2/13) ("Act"), reinstated the credit retroactively for the two-year period beginning 1/1/12 through 12/31/13. The credit is more likely to be made permanent than it is to go by the wayside. The most recent extension provided all companies another opportunity to either take advantage of the credit or face competition that already has done so. Qualified companies conducting a cost-benefit analysis should consider that most states also offer their own R&D tax credits that require documentation similar to that of the federal credit, which significantly increases the benefits side of the equation.

The Act also included two major modifications. First, it revised the treatment of acquisitions and dispositions. Under the Act, a taxpayer acquiring a trade or business prorates the target's QREs, gross receipts, and related base period effect using the number of days between the acquisition date and the end of a controlled group's tax year. The Act provides similar treatment for the disposition of a trade or business. Second, the Act modified the method by which the R&D credit is allocated to the mem-

EXHIBIT 1
Four types of R&D tax credit qualifying research activities



Note: New or incremental to the company, not the industry or world.

bers of a controlled group of corporations. A controlled group is any two or more corporations connected through a common stock ownership percentage of at least 80%.

Prior to the Act, there were two different allocation methods based on the ratio of the standalone credit to the group credit, and the ratio of standalone QREs to group QREs. The proper method to use depended on the amount of the group credit as compared with the sum of the standalone credits. Under the Act, regardless of the amount of the group credit compared with the sum of the standalone credits, the R&D credit allocable to the members of a controlled group is based on their proportionate share of the aggregate of the QRE.

In September 2013, Treasury and IRS issued taxpayer-friendly proposed regulations (REG-124148-05, 9/5/13) that would amend the Section 174 definition of "research and experimentation" expenditures. Under Section 174, taxpayers may either deduct R&D expenditures currently as they are paid or incurred, or treat them as deferred expenses amortizable over a period of not less than 60 months. Under the existing Regulations, a determination of whether costs qualify as R&D expenditures depends on whether the costs are required R&D expenses critical to activities intended to discover information that would eliminate uncertainty. The IRS is proposing that if expenditures do qualify as R&D expenditures during the course of the development effort, it will no longer matter if the resulting product is ultimately sold or is used in the taxpayer's trade or business.

Also, the IRS announced in an August 2012 Large Business & International (LB&I) Directive that it would no longer use the "tiered issue process" to determine exam priorities and address corporate tax issues, freeing the R&D credit from its historical designation as a Tier I audit issue.[11] This designation has long discouraged companies from using the credit for fear of increased audit scrutiny. The level of compliance risk should now be less of a concern for qualified companies wanting to pursue R&D credits.

In addition, a taxpayer can submit a prefiling agreement application with the IRS to request consideration of an R&D credit issue before a return is filed and thus resolve potential disputes earlier in the examination process. This program reduces the cost and burden of a postfiling

[11] LB&I-4-0812-010, 8/17/12.

[12] 2001-9 IRB 745.

[13] H.R. 4438, "American Research and Competiveness Act of 2014."

[14] S.2260, "EXPIRE Act of 2014."

[15] Holtzman, "Building Your R&D Tax Credit Claim on a Solid Foundation: The Architectural, Engineering, and Construction Industry," Construction Accounting and Taxation, pp. 5-13 (May/June 2014).

[16] Section 41(d)(4).

examination, provides a level of certainty regarding a transaction, and makes better use of taxpayer and IRS resources. Detailed information about the prefiling agreement application process is in Rev. Proc. 2001-22.[12]

Government officials, knowing that innovation is critical to a company's success and to overall U.S. economic growth, have legislated alternative calculation options to encourage U.S. companies to invest in R&D and to make the credit more valuable and obtainable. The alternative simplified credit (ASC) is the most recent example, removing complications inherent in prior calculation methods and significantly easing the R&D credit's documentation burden. The IRS has removed a longstanding restriction limiting the ASC election to originally filed returns. Effective 6/3/14, the IRS will now allow companies to go back and claim R&D credits on amended returns using the ASC method for all open tax years. This will significantly ease some recordkeeping and documentation requirements that have prevented companies from claiming R&D credits in prior years.

Legislators have also expanded the definition of what qualifies as R&D to include "process improvements," making the credit available to many previously excluded industries such as energy exploration, software development, financial services, and even the food and beverage industry.

As of the writing of this article, the R&D credit has not been renewed for tax years ending after 12/31/13. The House of Representatives recently approved legislation[13] that would permanently extend and simplify the R&D credit, as well as raise the percentage used in ASC methodology from 14% to 20%. The Senate passed legislation[14] that extends the current credit until 12/31/15 and allows some start-ups to claim the credit against payroll taxes and some privately held companies to claim it against their alternative minimum tax. This is the first step toward ending a 33-year lapse-and-revival cycle that has frustrated companies including Intel Corp. and Agilent Technologies, Inc.

Qualifying and nonqualifying R&D activities in the food and beverage industry

Qualifying R&D activities as they apply to the food and beverage industry generally fall into one of four general categories (see Exhibit 1)[15]:

1. New product development.
2. Incremental product development.
3. New process development.
4. Incremental process development.

Examples of QRAs include developing new flavors, appearances, textures, and health benefits, and extending shelf life. A new or improved product development could include the following initiatives that may qualify as research: improving the taste or nutritional content of food product formulations; incorporating new or sustainable ingredients in a formula; or producing sample batches in a test kitchen or pilot run. Other examples of initiatives are designing and developing products, such as low carbohydrate or trans-fat-free products. In some circumstances, obtaining gluten free, nut-free, allergen free, or kosher or halal certification could also qualify.

In addition, new manufacturing process development or improvements to the manufacturing process to enhance efficiencies as well as reduce the risk of spoilage and contamination may qualify for the R&D credit.

Other examples of qualifying activities include:

1. Improving manufacturing technology, processes, and procedures to increase yield, reduce waste and byproducts, improve safety, or comply with EPA or FDA requirements.
2. Developing new packaging and packaging systems or redesigning existing packaging.
3. Manufacturing experimental batches and pilot runs.
4. Developing new tools and unique kitchen equipment.
5. Developing techniques that will reduce costs or improve product consistency.
6. Redesigning machinery and equipment to ensure safe handling of food.
7. Creating new packaging to improve shelf life, durability, or product integrity.
8. Reducing materials or using more environmentally friendly materials in packaging.
9. Introducing new chemicals or alternative materials to improve packaging.
10. Creating new methods for minimizing contamination, scrap, waste, and spoilage.
11. Increasing energy efficiency of water, fuel, and utilities through introduction of new technologies.

Examples of activities that will not qualify for R&D credit purposes[16]:

EXHIBIT 2
Alternative simplified credit (ASC)

ASC = (current year QRE – (average of previous 3 Years QRE × 50%)) × 14%

EXHIBIT 3
Regular (traditional) credit method

regular = 20% of the smaller of ((current QRE – base period amount) or (50% of current QRE))
+ 20% (current payments to universities – base period amount)

EXHIBIT 4
Base period amount

base period amount = fixed base percentage × average of the prior four years gross receipts

EXHIBIT 5
Reduced ASC credit

If the special election is made under Section 280C(c)(3), the allowable credit is determined as follows:

ASC = (current year QRE – (average of previous 3 years QRE × 50%)) × 9.1%

EXHIBIT 6
Reduced regular (traditional) credit method

Regular = 13% of the smaller of ((current QRE – base period amount) or (50% of current QRE))
+ 13% (current payments to universities – base period amount)

1. Routine testing or inspection activities for quality control.
2. Development related to purely aesthetic properties of a product or packaging.
3. Testing and qualification of production lines.
4. Production line modifications that do not involve technical uncertainty, i.e. trouble shooting involving detecting faults in production equipment or processes.
5. Market research for advertising or promotions.
6. Routine data collections.
7. Research conducted outside the U.S., Puerto Rico, or any U.S. possession.
8. Research that is funded by a third-party other than the taxpayer.
9. Any other activities that do not meet the four tests discussed above.

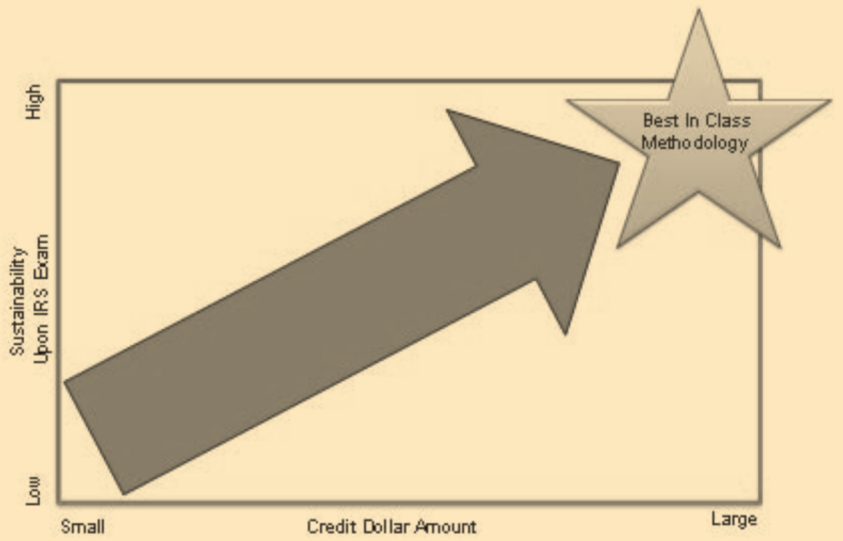
[17] Holtzman, *Supra* note 15.

Calculating the R&D credit

Since 2007, taxpayers have been able to compute their R&D credit using one of two sets of rules: the regular R&D tax credit rules or the alternative simplified credit (ASC) rules. The regular R&D credit, (Exhibit 3) which is equal to 20% of a business's qualifying research expense over a base amount (most often dated back to the 1984-1988 tax years) can be more favorable. The ASC (Exhibit 2), on the other hand, is equal to 14% of a business's qualifying research expense over the prior three tax period base amount. Companies that have not claimed the R&D credit in the past or that may have difficulty determining their historical QRE may find the ASC method beneficial. The complicated base-period rules combined with the difficulty of gathering sufficient documentation for the base years for the regular R&D credit make the ASC appealing in many situations.

Historically, taxpayers could elect to use the ASC on only a timely filed original tax return.

EXHIBIT 7
Optimizing the R&D credit



However, the new Regulations, issued in Treasury Decision 9666, allow taxpayers to make the ASC election on amended returns as long as a regular credit election was not already made previously for the year.

Taxpayers can elect to claim a reduced research credit under either the ASC (Exhibit 5) or Regular Research credit regime (Exhibit 6) in lieu of adding back the expenses (Section 280C election), but a Section 280C election must be made on a timely filed tax return. If the election is not made on a timely filed return, either credit calculation method can still be used, however, federal and state tax returns will need to be amended for the expenses used in the calculations. The research credit is reported on Form 6765, Credit for Increasing Research Activities.

Conclusion

The R&D credit is an important competitive factor for food and beverage manufacturers because it can lower the effective tax rate and refuel their R&D efforts through increased cash flow. Food processors and developers are constantly working on creating new products and improving the quality, taste, texture, and safety of foods and beverages. Federal tax credits provide permanent benefits by reducing the cost of R&D. While claiming the credit requires time, resources, and expertise, it can provide significant monetary and operational benefits to businesses. Even companies currently operating at a loss may benefit because federal R&D credits generated but not used can be carried back one year and forward up to 20 years creating an opportunity when the company becomes profitable. Also, if a company is acquired, the credits can be a valuable future asset in negotiating a selling price for the business. When credits are claimed correctly, companies can reap benefits including optimization of engineering investments and a dollar-for-dollar reduction in tax liability.[18]

The R&D credit can be a powerful incentive, often providing a hidden source of cash from prior years' expenses while also serving as a tool for refueling a company's R&D efforts. Planning ahead by creating an infrastructure that identifies QRAs and collects contemporaneous documentation is essential to reducing future tax liabilities and building R&D credit on a more solid foundation. It is worthwhile for companies in the food and beverage industry to take a close look at internal processes and think about whether they might benefit from this tax credit.

The R&D credit expired most recently on 12/31/13. A permanent R&D credit would create stability and certainty and catalyze investment by the private sector. It would place American companies, especially American manufacturers, on par with their international competitors who already have permanent R&D incentives. ■