Could Innovative Nutrition Yield a Healthier Tax Position? It's Worth a Look.

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The nutrient industry has seen a fountain of innovation in recent years. With almost 2 billion adults either overweight or obese, and more than 800 million underweight, the world faces significant health and wellness challenges. Nutrition innovation has never been more important.

Some innovations include targeted nutrition—a personal approach to nutritional products and dietary guidance for individual behavioral change. Why is this important/valuable? Food is a complex mixture of calories and dietary chemicals,

some of which are directly related to non-communicable diseases, such as diabetes, heart disease and some cancers.

Other technological advances have allowed for tectonic changes in the industry, combining health diagnostics, digital coaching and personalized nutrition to provide a holistic approach to managing and optimizing health. Digital platforms allow the individual access to registered dietitians, and an understanding of lifestyle, nutrition, exercise and other health factors. Furthermore, artificial intelligence (AI) is being used to develop comprehensive health and wellness solutions and educational tools to better manage and optimize overall individualized nutritional value. Data analytics tools and algorithms have been built based on the collection and analyses of large volumes of data related to users' dietary practices, physical activity, sleep patterns, nutrient safety, immune health, as well as other metrics. Other areas of related scientific advances include discovery in the fields of human genomics and microbiomics.

To succeed in this competitive space, development of new products that capitalize on market trends while minimizing manufacturing costs is essential to achieving sustainable margins and profitability for the long run. Since the industry is fueled by innovation, many of the development activities performed by companies in the industry may qualify for research and development (R&D) tax credits.

Advancing the industry in a meaningful way requires a massive infusion of capital. R&D tax credits are available to all aspects of the nutrient industry businesses that produce or develop new or improved products, processes, methodologies, principles or materials. Nutrient manufacturers can address the cost and risk of research and development by leveraging available federal, state and local tax incentives. The failure of small businesses to take advantage of the R&D tax credit means they miss a huge opportunity for taxpayers. We believe that this happens because there is self-censoring; business owners and their tax advisors have a fundamental misunderstanding of what is required to qualify for the R&D tax credit, which incentivizes an enormous range of activities, including many that most nutrient companies engage in. Furthermore, small business owners feel that these credits only apply to large corporations, when in fact they can have a huge impact on their companies.

The R&D tax credit is a great source of non-dilutive funding. In addition to "revolutionary" research activities, in some cases, the credit may be available if the company has performed "evolutionary" research activities such as investing time, money and resources toward improving its products and processes. These include, but are not limited to:

- Design and development of new products or processes
- Improving manufacturing technology, processes and procedures to improve taste, increase yield, reduce waste and byproducts, improve safety, or comply with EPA (Environmental Protection Agency) or FDA (U.S. Food and Drug Administration) requirements
- Developing new packaging and packaging systems, redesigning existing packaging, and reducing materials or using environmentally- friendly materials in packaging
- Manufacturing experimental batches and pilot runs for the R&D department
- Developing new tools and unique kitchen equipment
- Nutrient development – personalized nutrition
- Using AI and data analytics for diagnostics
- Health foods
- Food processing
- Targeted nutrition
- Food safety
- Discoveries in human genomics.
- Discoveries/research in microbiomics.
- Packaging design.
- Developing techniques that will improve product consistency.
- Redesigning machinery and equipment to ensure safe handling of food-nutrients.
- Creating new methods for minimizing contamination, scrap, waste and spoilage.
- Increasing energy efficiency of water, fuel, and other utility systems through the introduction of new technologies

Developing new or improving nutrient-dense food and beverage products, experimenting with new product formulations, equipment, automation technologies

or packaging systems, and optimizing production techniques or processes, may enable a company to qualify for the R&D tax credit.

How Does the Research & Development Tax Credit Work?

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

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

- Wages paid to employees for qualified services;
- Supplies used and consumed in the R&D process;
- Contract research expenses (when someone other than an employee of the taxpayer performs a QRA on behalf of the taxpayer, regardless of the success of the research); and
- Basic research payments made to qualified educational institutions and various scientific research organizations.

For an activity to qualify for the research credit, the taxpayer must show that it meets the following four tests;

- The activity must rely on a hard science, such as engineering, computer science, biological science or physical science;
- The activities 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;
- Technological uncertainty must exist at the outset of the activities. Uncertainty exists 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; and
- 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 the activities qualify, a thorough analysis must be performed to determine that the taxpayer has assumed the financial risk associated with, and will have substantial rights to, the products and/or processes that are developed through the work completed. The next step is to develop a methodology for identifying, quantifying and documenting project costs that may be eligible for the R&D credit. Costs that qualify for the credit include wages of employees involved in developing new or improved products or processes, supplies used or consumed during the research process, and 65 percent of fees paid to outside contractors who provide qualifying R&D services on behalf of the taxpayer.

Appropriate documentation may require changes to the company's recordkeeping processes because the burden of proof regarding all R&D expenses claimed is on the taxpayer. The company must maintain documentation to illustrate nexus between qualifying research expenses and qualifying research activities. Furthermore, a careful analysis should take place to evaluate whether expenses associated with eligible activities performed in the company outside of the R&D department may have been missed and can be included in the R&D tax credit calculation. This is accomplished by interviewing personnel directly involved in R&D or those who work in support or supervision of R&D efforts.

Calculating the Federal R&D Tax Credit

There are currently two available methods for calculating the federal R&D tax credit. The traditional or "regular" method relies on a base period of expenses and gross receipts from the mid-1980s, which can prove cumbersome to many companies. The more recently introduced Alternative Simplified Credit (ASC) method has become popular because it only requires examination of expenses in the credit year and for the prior three years.

The regular credit is computed by measuring qualified expenses as a percentage of a business's gross receipts and a higher percentage is applied to qualifying expenses than with the ASC method. Thus, if a business is increasing its QREs as a percentage

of gross receipts measured against a historic period, it will likely be eligible for the regular credit, but the recordkeeping requirements can be onerous and may make the ASC method more attractive despite the difference in the applied percentage. The ASC is a less burdensome methodology to compute the research credit. Generally, the credit is equal to 11 percent of a business' increase in QREs in the current year over 50 percent of average QREs in the prior three years.

Correctly calculating your research credits is critical because these can be used to lower a company's effective tax rate. For companies in net loss positions, the federal R&D credit may be carried back one year and carried forward for 20 years until it can be used. The key to accurately calculating R&D tax credits is distinguishing between qualified and nonqualified research activities and expenses. The distinction is often not tracked clearly by a company's accounting and project management systems, as book and tax definitions differ. As a result, many allowable expenses can be overlooked by taxpayers.

The Protecting Americans from Tax Hikes (PATH) Act of 2015 made the R&D Tax Credit permanent and made the R&D Tax Credit more available than ever to small and mid-sized businesses. The Tax Cuts and Jobs Act of 2017 lowered the corporate tax rate, while preserving and keeping permanent the R&D Tax Credit for qualifying U.S. businesses. Changes to the PATH legislation include:

- U.S. businesses and business owners with revenues less than $50 million can now use the R&D Credit to offset their alternative minimum tax (AMT); and
- Start-up companies, as defined, with gross receipts less than $5 million can now use the R&D Credit to reduce their payroll tax liability. 2023 R&D Tax Credit Updates.

The IRS has extended the grace period for refining research credit refund claims, granting taxpayers an additional 45 days. Instead of the previous deadline of Jan. 10, 2024, taxpayers now have until Jan. 10, 2025, to address claims that were filed promptly but lack essential information.

In a chief counsel memorandum released on Oct. 15, 2021, the IRS outlined additional detailed information necessary for valid research credit refund claims. According to the Treasury regulations, a valid refund claim must present sufficient

facts to inform the IRS of the claim's basis.

Referred to as the "five essential pieces of information required by a taxpayer for the IRS to adequately assess whether the refund claim can be paid or necessitates further examination," these include:

1. Identification of all relevant business components related to the research claim.
2. Identification of all research activities conducted for each business component.
3. Identification of all individuals involved in each research activity for each business component.
4. Identification of all information sought by each individual for each business component.
5. Total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses.

These requirements are intended to streamline IRS decisions, distinguishing claims that can be promptly paid from those requiring further examination.

The Evolution of Deductions for Research and Experimental Expenditures and Their Business Impact

The enactment of the Tax Cuts and Jobs Act in 2017 brought about significant changes, eliminating the option for taxpayers to deduct specific research or experimental (R&E) expenditures under Internal Revenue Code Section 174. This change, effective for tax years beginning after Dec. 31, 2021, mandates that taxpayers now capitalize and amortize these expenses over five tax years for U.S. spending and 15 years for foreign expenditures.

On Sept. 8, 2023, the IRS issued Notice 2023-63 (referred to as the "Notice"), providing interim guidance on the updated Section 174 rules. The Notice offers direction on various provisions, including:

- Defining specified research or experimental (SRE) expenditures.

- Describing costs falling under SRE guidelines and necessary allocations.
- Addressing the treatment of software development costs.
- Determining which taxpayer is responsible for reporting costs when research is performed under contract.
- Outlining amortization requirements for property acquisition or disposition with SRE expenditures.
- Detailing the treatment of long-term contracts using the percentage of completion method of accounting.
- Providing guidance on cost-sharing updates.

Despite ongoing efforts by industry groups and companies to revert Section 174 rules to the prior version, allowing immediate deductibility for R&E expenditures, the current landscape requires taxpayers to comply with the rules outlined in the IRS Notice and anticipated future guidance. While there is hope for proposed legislation to reinstate previous deductibility options, preparation for adherence to existing regulations is essential.

The R&D tax credit remains a crucial competitive factor for nutrient manufacturers, offering the potential to lower effective tax rates and bolster R&D efforts through increased cash flow. Nutrient developers continually strive to enhance products in terms of quality, taste, texture and safety. Federal tax credits, although requiring time and expertise to claim, provide permanent benefits, reducing the cost of research and development and generating cash flow.

For companies incurring expenses related to new product development or significant enhancements, the R&D credit is available. Proper identification, quantification and substantiation of employees' time spent on qualified research activities (QRAs) and related expenses are essential for filing a comprehensive, defensible claim. It is advisable for companies in the nutrient industry to scrutinize internal processes and seek expert consultation to determine potential benefits from the R&D tax credit.

Yair Holtzman, CPA, MBA, MS, CGMA is a partner at Anchin where he is the leader of the firm's R&D Tax Credits Group, Life Sciences Industry Group and Chemicals and Energy Industry Group, as well as Co-Practice Leader of the Tax Credits & Incentives Group. He has more than 25 years of experience with national public accounting and management consulting firms, focusing on federal tax consulting

issues and consulting with senior executives on their tax credits and other strategy development and implementation. In his former role at a Big 4 accounting firm, Holtzman also served as the national subject matter expert for the chemicals and life sciences industries. His clients range in size from startup to Fortune 500 companies.