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Debunking Some Common R&D Tax Credit Myths

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R&D

Yair Holtzman, Gleb Gorkhover and Michael Ganz of Anchin Block & Anchin examine common myths that deter companies from claiming benefits of the research and development tax credit. ''A large segment of small- and medium-sized business owners and management teams haven't taken advantage of this opportunity,'' the authors write. ''These businesses may be unaware that their company is in fact eligible for the benefit or may have accepted as gospel the prevailing R&D tax credit myths.''

Debunking Some Common R&D Tax Credit Myths

By Yair Holtzman, Gleb Gorkhover and Michael Ganz

The simple definition of research and development provided by Merriam-Webster Inc.'s dictionary is ''studies and tests that are done in order to design new or improved products.'' A key aspect we find missing from the definition, but that exists in the real world, is urgency.

Indeed, the rapid evolution of technology actually forces most companies to constantly innovate or face consequences. Failure to do so can quickly result in a company's demise. Successful companies therefore are always looking for ways to innovate and stay ahead of their competitors by developing new or improved products or trade processes.

Business owners who doubt whether the federal research and development (R&D) tax credit applies to their company should consider the extent to which they rely upon technology, engineering, science or sophisticated manufacturing techniques and methodologies. Even incremental product or process developments can potentially qualify. At every stage throughout the innovation process, from ideation through implementation or commercial production, companies frequently encounter technical challenges including but not limited to:

- project feasibility analysis;
- requirements identification;
- specifications determination;
- formulation of design alternatives;
- prototype creation—building, testing and evaluation;
- assembly methods and techniques development;
- process and equipment improvement;
- scalability;
- optimization of manufacturing processes; and
- integration issues.

Overcoming these challenging technical hurdles with intelligent, tested solutions is critical to running a successful business and thriving in the marketplace. Creating viable and worthwhile innovations can prove extremely expensive and time consuming. The Internal Revenue Code Section 41 R&D tax credit can help alleviate some of these financial pressures.

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Fortunately, our federal government as well as many states currently provide valuable economic incentives to counter the burden and reward companies for undertaking inherently risky projects and initiatives. The generous financial incentives are intended to foster the technological advancement of U.S. companies, thereby creating better jobs and increasing U.S. global competitiveness.

According to Internal Revenue Service Statistics of Income (SOI) Tax Stats, the largest U.S. corporations (with gross receipts greater than $250 million annually) have claimed more than 80 percent of all R&D tax credits in each year since 2007. A large segment of small- and medium-sized business owners and management teams haven't taken advantage of this opportunity. These businesses may be unaware that their company is in fact eligible for the benefit or may have accepted as gospel the prevailing R&D tax credit myths.

The purpose of this article is to help executives and upper-level decision makers obtain a better understanding of the R&D tax credit opportunity and its applicability to their particular business. The goal is to educate taxpayers who may be involved in qualified research projects and activities yet might not realize that their work does indeed qualify for the Section 41 credit. Each R&D tax credit myth will be examined and then an example included for illustrative purposes.

1. R&D Must Be Revolutionary

Myth No. 1: R&D must be revolutionary—to qualify you must be inventing something entirely new or groundbreaking.

Reality: This is probably the most pervasive R&D tax credit myth. In order to qualify for the R&D tax credit, development efforts don't need to be revolutionary to the world, or even to an industry. In 2003, the IRS abandoned its ''discovery test,'' which had imposed a requirement on companies that in order for their research activities to qualify they needed to obtain knowledge that ''exceeds, expands or refines the common knowledge of skilled professionals in a particular field of science or engineering.''

Under current regulations, development efforts only need to be evolutionary at the individual company level, not revolutionary.

Under current regulations, development efforts only need to be evolutionary at the individual company level, not revolutionary. These advances can include entirely new products or trade processes as well as significant improvement to existing ones. It doesn't matter if any other company has already undertaken the research, created the product or is already using the process or technique. So long as company employees are spending time to discover technical information through research and experimentation, with the intention of developing or improving products or trade processes, these expenses will likely qualify for the R&D tax credit according to Section 41 guidelines.

To be clear, regulations specifically exclude activities such as reverse engineering or following a well-defined blueprint.

Example: A manufacturer of breakfast muffins has always made fresh and delicious blueberry, cranberry and chocolate chip muffins, full of flavor (and calories). All of a sudden it realizes that sales are plummeting.

The company discovers that nearby competitors have developed equally tasty but healthier alternatives to their classic muffins. They have accomplished this feat by successfully formulating sugar-free, fat-free and even sodium-free varieties. These new products have been capturing a considerable portion of the breakfast muffin market. Furthermore, the competition has also figured out how to extend the shelf life of its products, thereby allowing them to reduce prices.

To the extent that our classic muffin manufacturer doesn't already know how to develop these healthier alternatives while also increasing shelf life and can't simply look up recipes and techniques, it will likely have qualifying research activities. Each project's qualifying expenses will likely include salaried employee time spent attempting to develop viable product and process solutions, as well as any ingredients used in experimentation, prototyping and trial production runs.

2. R&D Requires Labs and Scientists

Myth No. 2: To claim an R&D tax credit, a company should have laboratories and employ scientists.

Reality: The IRS definition of R&D, as spelled out in Section 41, is a lot broader than most companies realize. Simply put, a company doesn't need to be curing a disease, designing high-tech microchips or experimenting with lab chemicals in order to have qualifying research activities.

All a company needs to be doing is attempting to develop new products or trade processes by resolving technical uncertainties through experimentation using one of the sciences (engineering, physics, chemistry, biology or computer science). And it can even qualify by attempting to significantly improve existing products and processes by making them more functional, reliable, better performing or of a higher quality. By meeting this criterion, the IRS's four-part test is satisfied (also please see Myth No. 4).

Example: As part of its core business, a construction company is hired and tasked with recladding the exterior of buildings. The company has historically accomplished this by building a temporary wall around each building's entire perimeter.

The company determined that it could save numerous tons of construction materials, many thousands of employee man hours and that it could accomplish all of this while being more environmentally friendly by dramatically reducing waste and scrap. The concept was to develop a mobile, reusable wall system that could be deployed at one part of a building and then simply moved and re-used at other areas of the building as the project progressed.

Since this would be an entirely new process, a majority of the costs that the company incurs to develop this new system from conceptualization to implementation could potentially qualify for the R&D tax credit according to IRS guidelines. As with most qualifying projects, the primary expense to the company will be the wages it pays employees who are experimenting in an attempt

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to develop the solution. Additional qualifying costs might include supplies used in building and constructing the prototype, as well as any expenses paid to contractors for research or testing of appropriate designs or materials.

3. R&D Credits Won't Help Without Profits

Myth No. 3: R&D tax credits won't help my company because we aren't profitable.

Reality: In theory one might expect that a taxpayer wouldn't be able to utilize any type of tax credit unless it was profitable and therefore had a tax liability to offset. This isn't the case. Since inception, the federal R&D tax credit has been available to be carried back and forward so that it could still be utilized by companies that reported losses in the current year or couldn't utilize the credit for other reasons.

Current regulations allow taxpayers to carry credits back for one year and forward for up to 20 years, so unprofitable companies have always been able to benefit to the extent they reached profitability at some point in the future. Furthermore, the Protecting Americans from Tax Hikes (PATH) Act, which was passed by Congress and signed into law by President Barack Obama in December 2015, has provided more opportunity for unprofitable businesses to claim the R&D tax credit.

Beginning in tax year 2016 this legislation will allow development-stage businesses (gross receipts less than $5 million, and no gross receipts for any tax years preceding the five-tax-year period ending with the tax year) to claim the federal R&D credit against their payroll taxes (capped at $250,000 per year for five years). Many startup companies should be able to benefit.

Furthermore, unprofitable companies may be able to benefit from individual state research credits. There are a handful of states, including Arizona, Connecticut, Hawaii, Iowa, Maryland, Nebraska and Virginia, that offer refundable or partially refundable research credits. These credits are payable to the company even if it pays no tax at all.

Example: An Arizona software company was founded in 2015 and had been researching for all of tax year 2015 to create a new trading platform for hedge funds. It has invested heavily in salaries of highly technical software developers who are trying to design and optimize the code that will eventually meet all identified requirements for the new product. During 2015, the company had no revenue, as the product hadn't yet been released to the market. Since it had no revenue, it had no profit and therefore it had no federal or state income tax liability.

The company can still claim a federal research and development tax credit. The credit amount can be carried forward until the company reaches profitability (for up to 20 years). The company can also claim the Arizona state credit for increased research activities, which is a partially refundable state credit. This means that the credit amount claimed from Arizona will be newfound cash for this development-stage company.

4. The Research Deduction Undercuts The R&D Credit's Value

Myth No. 4: The R&D tax credit can't be significant, since my company is already taking a deduction for research expenses under Section 174.

Reality: Tax credits are inherently more powerful than tax deductions, as they represent a full dollar-for-dollar offset in taxpayer liability. Tax deductions merely reduce taxable income by the amount of qualified expenses, thereby saving the taxpayer the expense amount times their tax rate, usually around 35 percent.

When claiming the R&D tax credit, taxpayers can make an election under Section 280C that allows them to take a 35 percent reduced R&D tax credit while keeping their Section 174 deduction. The reduced R&D tax credit amount is then entirely supplemental to the taxpayer's 174 deduction. Coincidentally, the initial criteria for qualifying expenses for the federal R&D tax credit is that expenses need to be classified as experimental expenses according to Section 174.

Example: A medical device company has undertaken to develop a new activity tracker that can be worn on the wrist and will accurately measure an individual's calories burned and their heart rate. The company needs to figure out whether or not it has the capability to develop this innovative product. This includes identifying and resolving technical design and development uncertainties.

Most expenses incurred by the taxpayer in this endeavor will qualify as experimental costs under Section 174. There are then three additional criteria that need to be met in order to also qualify these expenses for the R&D tax credit. Per Section 41, the expenses must also be related to:

- performance of technical activities or discovering technical information;
- developing a new improved business component (product or trade process); and
- evaluating alternatives through a process of experimentation.

After all four criteria have been met and the Section 41 claim has been calculated on Form 6765, Credit for Increasing Research Activities, the taxpayer can then elect to reduce its R&D tax credit claim by 35 percent, thereby allowing it to keep its Section 174 deduction. Ultimately a professional accountant may need to advise individual companies whether or not the Section 280C election makes sense based upon individual taxpayer circumstances.

5. The R&D Credit Is Only for the Large

Myth No. 5: The R&D credit is only for very large companies.

Reality: It is probably true that all Standard & Poor's 500 companies, the largest companies in the U.S., religiously claim the R&D tax credit. This is most likely because they have a battery of accountants and advisers who inform them of their eligibility for the generous credit. It is incorrect, however, to suggest that the R&D tax credit is only available to very large companies.

The R&D tax credit program is available to companies of any size. There are no size requirements or restrictions based upon revenue, number of employees, expenditure or any other metric. Eligibility for the R&D tax credit is based entirely on the qualifying nature of employee activities, projects and the related costs incurred.

In fact, the recently passed PATH legislation, was specifically designed and intended to make the federal R&D tax credit more readily available to smaller-sized companies. According to the legislation, in addition to helping startups apply the credit against payroll taxes, beginning in tax year 2016, small- and mid-sized businesses (less than $50 million in gross receipts) will now be allowed to apply the R&D tax credit against their alternative minimum tax (AMT). This will be a very powerful new incentive for many small business owners. As a result, we expect to see a spike in R&D tax credit claims.

Example: An entrepreneur founded an S corporation startup company that is attempting to facilitate problem-solving within groups, industries or communities by developing a website intended to become a common destination or hub for people seeking help on any number of issues. The company pays the entrepreneur's salary, staff and contractors, who were in charge of the design and development of the website's functionality. While the company is profitable, the entrepreneur is subject to AMT tax due to his other ventures.

Starting in 2016, the entrepreneur will be able to take advantage of the R&D credit by claiming it against his AMT liability.

6. No R&D Credit Without Success

Myth No. 6: We can't claim the R&D tax credit because our efforts haven't been successful.

Reality: Some may be surprised to learn that the majority of research projects undertaken in the U.S. will actually fail to achieve their goals and objectives. Very few will provide the expected or intended results, financial or otherwise. That is the nature of unknowns that require research and experimentation.

Section 41 regulations specifically state that success isn't a factor nor an eligibility requirement for claiming the R&D tax credit.

Section 41 regulations specifically state that success isn't a factor nor an eligibility requirement for claiming the R&D tax credit. In fact, if a company incurs expenses associated with a development-stage project or with a technology initiative that ultimately fails, its R&D tax credit claim will probably be made more sustainable upon IRS audit. This is because the failure is likely to be viewed by the IRS as the best available evidence to prove the activities were experimental in nature and that the outcome of the project or initiative was entirely unknown at the outset.

Example: An energy company undertook the daunting task of developing a biodiesel fuel for possible use in automobiles. The company sought to create a brand new product derived from vegetable oils and animal fats that could effectively power vehicles and equipment. Its intention was to provide an alternative to petroleum-based fuel, which is known to be inherently higher in harmful pollutants and contaminants. If successful, the company's solution would be beneficial to the atmosphere and significantly friendlier to the environment.

This was an extremely challenging initiative. There is a reason that none of the major oil companies that regularly invest in trying to develop petroleum alternatives has yet to bring a viable solution to market. Even if the company was able to successfully develop a product and process proven effective on a small scale, it would still need to develop a verifiable plan for mass production of the product.

Despite all of its good intentions, hard work and concerted efforts the company ultimately failed to achieve its goals. This failure in no way disqualifies or prevents the company from claiming the expenses it incurred during the project as qualified research expenses according to IRS guidelines.

7. No R&D Credit Where Expenses Are Flat

Myth No. 7: We aren't eligible because the R&D credit is for increasing research activities and the company's expenses have generally remained flat.

Reality: The R&D tax credit, according to Section 41 and Form 6765, is the ''Credit for Increasing Research Activities,'' suggesting that taxpayers will be rewarded for spending more on research activities in the current tax year compared with the recent past. In other words, it is a credit for incrementally increasing qualified expenditures.

However, according to the Form 6765 instructions, using the alternative simplified credit (ASC) methodology, the increase is measured and calculated by comparing a company's current tax year qualified research expenditures to half of the average research expenditures experienced during the prior three-year period. So even if a taxpayer's research and experimental spending has decreased in the current tax year, it might still be eligible for a tax credit, it will just be a lower amount.

Examples of R&D Tax Credit Calculations Using ASC

Scenario 1—Increasing R&D Tax Credit Expenditures. The taxpayer's qualified research expenses (QREs) increase at a rate of 10 percent annually:

- 2013— $1 million;
- 2014—$1.1 million;
- 2015—$1.21 million;
- 2016—$1.331 million.

2016 R&D Tax Credit Calculation: $1,331,000 – (($3,310,000/3) × 50 percent) = $779,333 × 14 percent = $109,107.

Section 280C Election: $109,107 × 65 percent = $70,920.

Scenario 2—Flat R&D Tax Credit Expenditures.
The taxpayer's QREs remain flat:

- 2013—$1 million;
- 2014—$1 million;
- 2015—$1 million; and

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- 2016—$1 million.

2016 R&D Tax Credit Calculation: $1,000,000 – (($3,000,000/3) × 50 percent) = $500,000 × 14 percent = $70,000.

Section 280C Election: $70,000 × 65 percent = $45,500.

Scenario 3—Decreasing R&D Tax Credit Expenditures. The taxpayer's QREs decrease at a rate of 10 percent annually:

- 2013—$1 million;
- 2014—$900,000;
- 2015—$810,000; and
- 2016—$729,000.

2016 R&D Tax Credit Calculation: $729,000 – (($2,710,000/3) × 50 percent) = $277,333 x 14 percent = $38,827.

Section 280C Election: $38,827 × 65 percent = $25,238.

It can be seen from the above examples that taxpayers will be entitled to a research credit in any of the above scenarios—whether qualified expenses increase, remain flat or decrease.

The following formula can be used to determine the point at which a taxpayer's R&D tax credit will be zero: 2016 QREs – (Base Period QREs/6) = 0.

Therefore, if Base Period QREs = $3 million, 2016 QREs would have to fall to $500,000 in order to yield no R&D tax credit under ASC methodology.

Taxpayers should be aware that when claiming the R&D tax credit on Form 6765, they have the option of making the Section 280C election. Making this election will allow taxpayers to take the 35 percent reduced R&D tax credit while entitling them to keep all of their Section 174 deductions.

8. R&D Can't Cut State Tax Liabilities

Myth No. 8: The R&D tax credit can't help reduce my company's state tax liabilities.

Reality: Thirty-six of the 50 states currently offer research credits and several others are looking to enact them. These individual state credits are entirely separate and in addition to the federal opportunity. In fact, states are continuously trying to outdo one another in an effort to attract promising new technology companies to their local geographies. Their hope is that these new development-stage companies will boost local employment and state revenue.

The credits are usually not limited to new companies or start-up stage companies. Furthermore, most of the state credit calculations are derived from the federal calculation and thereby rely upon similar methodology and qualification criteria for activities and expenses. Therefore, with an incrementally minor effort, significant additional state research tax credits may be available to local businesses. Some state research credits even have the potential to cover a taxpayer's entire tax obligation for the year.

It should be noted that individual state research credits will vary significantly, as each state will have its own credit offerings and calculation methodologies, and each offering will have its own restrictions and requirements for eligibility. The one common denominator is that all qualified expenses will need to be incurred within the state offering the credit, demonstrating state nexus. Employees who reside outside of the state and development expenses that are paid out of state will likely need to be excluded.

Example: A small chemical company based in Indiana that has been located in the state for 10 years had qualified research expenses this tax year of $500,000, compared with an average expense of $400,000 over the prior three years. Upon completing its federal Form 6765, the company's accountant said it would be entitled to an R&D tax credit of $27,500 this year.

The accountant also went ahead with his results and similarly calculated the alternative incremental credit for research conducted in Indiana on Form IT-20REC, Indiana Research Expense Tax Credit (#822). As a result, the company learned that it would also be receiving a tax credit of $30,000 against its Indiana tax liability. Combined, it will be saving $57,500 on federal and state taxes.

9. Tax Reform May Render The R&D Credit Unavailable

Myth No. 9: Tax reform may occur and the temporary R&D tax credit will no longer be available.

Reality: The federal R&D tax credit has always enjoyed strong bipartisan support in Congress, being renewed 16 consecutive times since its original enactment in 1981. Intended as a temporary two-year incentive to encourage R&D activity, manufacturing and hiring on U.S. soil, its popularity has kept it a part of the tax code for more than 30 years.

In his campaign materials, Donald Trump states that he would like to preserve the R&D tax credit.

Now, with the recently passed PATH Act, the R&D tax credit is finally a permanent part of our tax code. In fact, the R&D tax credit was by far the largest single item in the legislation, estimated to cost our government approximately $113 billion over the next 10 years. So there is little if any risk left for the longevity of the R&D tax credit and the fact that it has been made permanent and even expanded to include a larger population of taxpayers should encourage business owners and management teams to seriously consider taking full advantage.

However, rigorous and detailed documentation and substantiation of qualified research expenses is of greater importance than ever before, as a permanent R&D tax credit makes it a desirable IRS exam target. Taxpayers should expect a higher level of scrutiny and if activities aren't properly documented and regulations properly applied, research credit claims may be significantly reduced or disallowed entirely in the case of an IRS examination.

The recent election of Donald Trump should also not jeopardize the R&D tax credit. In Trump's tax reform plan, a number of deductions and credits are expected to be eliminated to pay for the lower top corporate income tax rates proposal. However, in his campaign ma-

terials, he states that he would like to preserve the R&D tax credit.

10. The R&D Tax Credit Doesn't Apply to My Industry

Myth No. 10: The R&D tax credit doesn't apply to my industry, and if it does it is just too good to be true.

Reality: Thousands of companies from dozens of industries will claim the federal R&D tax credit each and every year. The most recent SOI Tax Stats show nearly 16,000 corporations from 14 broad sectors claiming Section 41 R&D tax credits. These credits apply not only to high-tech manufacturing, alternative energy and pharmaceuticals, but also to food, chemicals, medical devices, apparel, financial services, software, transportation, mining, utilities and various other industries.

Taxpayers should recognize the critical importance of this benefit and consider how it applies to their company. And it isn't only the financial benefit that should be considered. By opportunistically appropriating resources toward R&D for product or trade process innovations, companies should expect to reap additional rewards including revenue growth, optimization of systems and operations, increased competitiveness and sustainability.

Conclusion

For decades the R&D tax credit has been misunderstood and prevailing myths widely accepted as truths. We hope this article has provided some guidance on how the R&D tax credit may apply to a broad range of companies. Research credits at the federal and state levels are important incentives for U.S. companies that develop or improve products or trade processes using technology.

Now a permanent part of the tax code, much uncertainty surrounding the federal credit has been removed. PATH Act legislation has also opened up the R&D tax credit, making it available to many small- and mid-sized companies previously unable to utilize it because of their tax situations. Beginning in tax year 2016 many of these business owners in AMT situations will be able to apply the R&D tax credit against their tax liability. Additionally, many businesses with no tax liability will be able to apply the credit against their payroll taxes.

These powerful incentives provide benefits by driving down effective tax rates, generating cash flow and providing fuel for the next R&D cycle. While properly claiming the credit in accordance with IRS guidelines still requires a concerted effort of time, resources and expertise, the financial and operational advantages for qualified businesses are compelling.

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