

R&D Tax Credit

How Manufacturers Can Realize the Benefits of the R&D Credit

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R&D Tax Credit

How Manufacturers Can Realize the Benefits of the R&D Credit

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R&D Tax Credit Agenda

- Benefit
- Eligibility
- Claiming
- Other Considerations
- Q&A
- Contacts





Benefit

What are the benefits of the R&D credit?



R&D Tax Credit - Update

Benefit

- **Federal** - net tax benefit = up to 9.1% of qualified spending. Usually less.
- **States** - net tax benefit =
 - Pennsylvania -
 - For “small” businesses = up to 10% of qualified spending.
 - “Small” businesses = those whose net book assets are less than \$5 million.
 - Credit sunsets Jan. 1, 2016.
 - For non-“small” businesses = up to 5% of qualified spending.
 - Other states = 0% to up to 40% of qualified spending.
- **Increase cash flow.**
- **Reduce effective tax rate.**

R&D Tax Credit - Update

Benefit (cont'd)

Example - for a Pennsylvania "small" business

	2007	2008	2009	2010	Total
Qualified spending [1]	100,000	100,000	100,000	100,000	
Potential credits					
Federal [2]	6,500	6,500	6,500	4,550	24,050
Pennsylvania [3]	10,000	10,000	10,000	10,000	40,000
	16,500	16,500	16,500	14,550	64,050

[1] Note assumption that qualified spending doesn't increase year to year.

[2] In part because of [1], federal benefit doesn't equal 9.1% of qualified spending.

[3] The Pennsylvania credit must be applied for each year and can be used to offset 100% of:

It can be used to offset 100% of:

- Capital stock and franchise tax (CSFT);
- The corporate net income tax (CNIT); and
- The personal income tax (PIT).

but none of employer withholding taxes.

If you can't use it in a taxable year, it may be either:

- Carried forward 15 years; or
- Sold or assigned to another business, who can use it to offset up to 75% of its tax liability for a taxable year but cannot carry it back or forward or resell it.

R&D Tax Credit - Update Benefit (cont'd)

Pennsylvania Credits Claimed by Small Businesses

"Small" businesses are businesses with net book assets of less than \$5 million.

Credit Awarded		Tentative		
Dec.	# of Applicants	Credit	Approved Credit	Limit [1]
2011	n/a	n/a	n/a	8,000,000
2010	n/a	n/a	n/a	3,600,000
2009	211	8,688,383	4,000,000	4,000,000
2008	205	8,052,975	8,000,000	8,000,000
2007	193	6,845,879	6,845,879	8,000,000
2006	173	7,081,079	7,081,079	8,000,000
2005	108	2,268,046	2,268,046	8,000,000

[1] Pennsylvania limits the amount of credits it provides each year.



R&D Tax Credit - Update Benefit (cont'd)

Pennsylvania Credits Claimed by Industry in 2009

Business Type	Number of Taxpayers	Actual Credit	% of Total
Manufacturing	225	11,157,445	56%
Services	192	5,393,484	27%
Misc.*	90	3,449,071	17%
Total	507	20,000,000	100%

* Misc. business type includes business activities associated with individuals or corporations with standard industrial classification (SIC) codes for the agriculture, construction, utilities, wholesale, retail or financial, insurance and real estate sectors.

R&D Tax Credit - Update Benefit (cont'd)

Federal Credits by Sector - 2008

In 000s

	# of Returns	Credits	Avg. Credit
Manufacturing	5,420	5,758,082	1,062
Information	1,132	944,284	834
Professional, scientific, and technical services	3,932	787,671	200
Wholesale and retail trade	865	430,098	497
Finance and insurance	237	142,599	602
Management of companies (holding companies)	276	62,091	225
Utilities	129	48,855	379
Various services*	194	43,942	227
Mining	36	29,997	833
Administrative, support, and waste management services	288	22,373	78
Transportation and warehousing	58	10,593	183
Construction	56	10,278	184
Real estate, rental, and leasing	30	7,453	248
Agriculture, forestry, fishing, hunting	83	5,054	61
Total	12,736	8,303,370	652

* Various Services include educational services; health care and social assistance; arts, entertainment, and recreation; accommodation and food services; and other services.

Source: <http://www.irs.gov/taxstats/article/0,,id=164402,00.html>.

R&D Tax Credit - Update Benefit (cont'd)

Federal Credits by Manufacturing Subsector - 2008

In 000s

	# of Returns	Credits	Avg. Credit
Computer and electronic product	1,319	1,812,225	1,374
Chemical	701	1,489,383	2,125
Transportation equipment	291	1,180,968	4,058
Machinery	651	339,851	522
Miscellaneous	575	279,958	487
Electrical equipment, appliance, and component	555	217,724	392
Petroleum and coal products	40	99,858	2,496
Food	163	80,719	495
Fabricated metal product	457	74,863	164
Paper	58	64,226	1,107
Primary metal	116	32,098	277
Plastics and rubber	202	31,366	155
Beverage and tobacco product	18	12,844	714
Nonmetallic mineral product	70	12,283	175
Furniture and related product	70	11,240	161
Textile mills and textile product mills	22	5,249	239
Wood product	14	5,016	358
Printing and related support activities	38	4,417	116
Apparel	55	2,315	42
Leather and allied product	6	1,478	246
Total	5,421	5,758,081	1,062



Eligibility

Does your business qualify for the R&D credit?



R&D Tax Credit - Update

Eligibility

- Activities
- Costs
- Credit calculations
- Other



R&D Tax Credit - Update Eligibility (cont'd)

Activities - Common Misconceptions

- “Our product hasn’t changed in 50 years...”
- “Our products aren’t technical in nature...”
- “We have been running a loss for years...”
- “There’s not enough documentation to support the credit...”
- “The IRS is sure to audit and disallow an R&D Credit claim...”
- “It’s probably not even worth taking the time or effort to explore...”



R&D Tax Credit - Update

Eligibility (cont'd)

Eligible Activities - Types

- Energy Research
 - Research related to energy's production, supply, or conservation of energy.
 - Examples: research regarding hydrogen fuel cell vehicles or energy-efficient lighting.
- Basic Research
 - Any original investigation
 - For the advancement of scientific knowledge
 - Not having a specific commercial objective.
- Qualified Research



R&D Tax Credit - Update Eligibility (cont'd)

“Qualified Research” means activities that meet these four tests—IRC sec. 41(d):

- Permitted Purpose Test - intended to develop or improve the functionality, performance, reliability, or quality of a “business component,” *i.e.*, a product, process, software, technique, invention, or formula;
 - “Intended” - success is not required.
 - The level of technological advancement is not relevant.
- Process of Experimentation Test - through a process designed to evaluate one or more alternatives to achieve a result where:
- Technological in Nature Test - that process fundamentally relies on the principles of engineering or the physical, biological, or computer sciences; and
- Uncertainty Test - the capability or the method of achieving that result, or the appropriate design of that result, is uncertain at the activities’ beginning.

and are not excluded by statute...



R&D Tax Credit - Update Eligibility (cont'd)

Statutorily-Excluded Activities—IRC sec. 41(d)(4)

- Related to style; taste, except biological taste; cosmetic or seasonal factors.
- Relies on social science, arts, or humanities. Must be “technological in nature.”
- Funded by an unrelated person or governmental entity.
- Conducted outside the U.S.
- Management surveys, efficiency studies, market research, *etc.*
- Routine data collection and ordinary quality control.
- Intended to develop software primarily for “internal-use.” Exceptions exist.
- The following activities, unless they meet the four-part test outlined above:
 - After commercial production.
 - Adapting an existing component to a particular customer’s requirements.
 - Duplicating an existing business component.



R&D Tax Credit - Update

Eligibility (cont'd)

Qualified Research - Examples

- Basic R&D.
- Product development.
- Manufacturing process improvements, *e.g.*, to make things better, faster, cheaper.
- Software development, whether software is for sale, license, or internal use.
- Evaluating the efficiency of a third party's technology to perform within an existing production process. *Union Carbide*.
- Specifying and integrating existing components into an overall design for a new system. *Trinity* (integrating existing components into a new ship design).
- Additional design and engineering work to modify molds purchased from third parties so that they can be used to produce desired components. *TG Missouri*.



R&D Tax Credit - Update Eligibility (cont'd)

Qualified Research - Examples (cont'd)

Attempts to improve products' and production processes':

- Performance, quality, and reliability.
- Formulas.
- Use of new equipment in an existing production process.
- Use of new materials.
- Software.
- Production controls.
- Automation and streamlining processes.
- Specialized machinery and fixtures.
- Prototypes, models, and computer simulations.
- Tools, jigs, molds, and dies.
- Waste, spoilage, and defect reduction.
- Environmental and green friendliness.
- Quality control.
- Design validation or certification testing.

R&D Tax Credit - Update Eligibility (cont'd)

Eligible Costs - Types

- Qualified Research Expenses (“QREs”).
- Basic Research Payments (“BRPs”).
- Energy Research Payments (“ERPs”).

How Costs Are “Credited”

- QREs: credit = % of increment of QREs over a base amount.
- BRPs: credit = % of increment of BRPs over a base amount.
- ERPs: credit = % of ERPs.

Examples	QREs A	QREs B	BRPs A	BRPs B	ERPs
Amount	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Base Amount	500,000	1,500,000	500,000	1,500,000	N/A
Excess	500,000	0	500,000	0	1,000,000
Credit	100,000	0	100,000	0	200,000



R&D Tax Credit - Update

Eligibility (cont'd)

Qualified Research Expenses (“QREs”)

- Wages: taxable—W-2, box 1—wages of employees who perform or directly supervise or directly support Qualified Research (“Qualified Services”).
 - Stock options qualify to the extent they are subject to withholding.
- Supplies: costs for tangible, personal property, not of a character subject to the allowance for depreciation, used in qualified research.
 - If a taxpayer doesn’t have an economic interest in the property, the property is not depreciable in the taxpayer’s hands and its costs can qualify. *T. G. Missouri* (taxpayer’s production molds, purchased from third parties, modified by taxpayer, and then sold to customers but still used in taxpayer’s production process, were not depreciable in taxpayer’s hands—because taxpayer didn’t have an economic interest in them—and so could be included as qualified supply costs).
 - “Use” is sufficient; “consumption” is not required. *Union Carbide*.
- Contractor Research Expenses: 65%, 75%, or 100% of payments to contractors for Qualified Services, depending on the nature and activity of the contractor, and provided the payments were not contingent on the activity’s success and the taxpayer retained substantial rights to the research’s results.



R&D Tax Credit - Update Eligibility (cont'd)

Basic Research Payments (“BRPs”)

- Cash payments
- By a corporation
- To a qualified organization
- Pursuant to a written agreement
- For any original investigation
- For the advancement of scientific knowledge not having a specific commercial objective.

Energy Research Payments (“ERPs”)

- Amounts paid to an Energy Research Consortium
- For Qualified Research
- Which is Energy Research.

Impact of Capitalization

- Sec. 174 expenses, whether capitalized or deducted, are eligible for the credit



R&D Tax Credit - Update

Eligibility (cont'd)

Credits in General (for QREs, BRPs & ERPs)

- Ways to calculate credit
 - Regular Credit - Form 6765 Section A.
 - Alternative Simplified Credit (“ASC”) - Form 6765 Section B.
- ASC Elections
 - Can be made initially only on timely-filed original returns.
 - Apply to the current tax year and all later tax years, unless revoked.
 - Can be revoked:
 - Only on timely-filed original returns, not on amended returns.
 - By reporting the Regular Credit, *i.e.*, completing Form 6765 Section A.
- Credit Calculation
 - All members of the same controlled group of corporations are treated as a single taxpayer.
 - All trades and businesses under common control are treated as a single taxpayer.
- Allocation
 - The credit (if any) allowable to each member or trade or business equals its proportionate shares of the QREs, BRPs, and ERPs giving rise to the credit.



R&D Tax Credit - Update

Eligibility (cont'd)

Credits in General (for QREs, BRPs & ERPs) (cont'd)

- Sec. 280C Election to Report the Reduced Credit
 - Prevents double benefit—deduction and credit—for the same expenses.
 - If not made, a taxpayer must reduce its deduction or capital account by the amount of the credit.
 - If the credit exceeds the amount allowed as a deduction for the tax year, it must:
 - Reduce the amount chargeable to capital account for the year for such expenses by the amount of the excess; and
 - Attach a schedule to its tax return that lists the deduction amounts (or capitalized expenses) that were reduced and identifies the lines of the return (schedule or forms for capitalized items) on which the reductions were made.
 - If made, the credit is reduced by the product of the unreduced credit and the maximum corporate tax rate, currently 35%. Example: unreduced credit = 100,000; reduced credit = 65,000.
 - Once made for any taxable year it is irrevocable for that year.
 - Made by claiming the reduced credit on a timely-filed original return for the taxable year or, if no credit is being reported on the original return, by checking the box for the sec. 280C election.
 - Controlled group members and commonly-controlled trades or businesses may make the election.
 - *Caution:* if invalidly made, penalties under sec. 6694 and sec. 6701 may be imposed.



R&D Tax Credit - Update

Eligibility (cont'd)

Credits in Particular

- For ERPs = % of ERPs. Volume based, not incremental. No base amount.
- For BRPs = % of BRPs that exceed Qualified Organization Base Period Amount.
- For QREs = % of QREs that exceed a base amount that can vary depending on:
 - QREs in the current tax year.
 - QREs in earlier tax years, possibly 1984-1988 or later years.
 - Gross receipts in earlier tax years, possibly 1984-1988 and later years.
 - All gross receipts are being properly included. Include/exclude foreign subs'/branches'. *Deere*.
 - Whether the taxpayer a “start-up company.” A taxpayer is a start-up company if it does not have QREs and gross receipts in:
 - Any one tax year beginning before 1984; or
 - More than two tax years beginning after 1983 and before 1989.
 - Whether the taxpayer is a controlled group member or commonly-controlled trade or business.
 - Whether QREs and gross receipts for acquisitions and dispositions made since possibly as early as 1984 of major portions of viable trades or businesses are properly accounted for.
 - Which credit is being calculated, the Regular Credit or Alternative Simplified Credit (“ASC”).

R&D Tax Credit - Update

Eligibility (cont'd)

Credits in Particular (cont'd) - Based on QREs

Regular Credit

	Base Amount	
	Minimum (50%)	Fixed Base %
1 QREs for credit year	1,000,000	1,000,000
2 Base Amount	500,000	1,000,000 *
3 Excess	500,000	0
4 Credit (20% of Excess)	100,000	0
5 Credit - Sec. 280C Reduced	65,000	0

* Base Amount Using Fixed Base %

6 QREs for tax years 1984-1988	10,000
7 GRs for tax years 1984-1988	1,000,000
8 Fixed Base %	1.00%
9 Average Annual GRs for 4 prior TYs	100,000,000
10 Base Amount	1,000,000

Alternative Simplified Credit

	QREs in Three Prior Tax Years		
	Yes	Yes	No
1 2009 QREs	1,000,000	1,000,000	1,000,000
2 2008 QREs	1,000,000	1	1,000,000
3 2007 QREs	1,000,000	1	1,000,000
4 2006 QREs	1,000,000	1	0
5 50% of Average QREs for 3 prior TYs	500,000	1	n/a
6 Excess	500,000	1,000,000	n/a
7 Credit (14% of Excess or 6% of QREs)	70,000	140,000	60,000
8 Credit - Sec. 280C Reduced	45,500	91,000	39,000



R&D Tax Credit - Update

Eligibility (cont'd)

Eligibility Summary

- Qualified Research, Basic Research, or Energy Research.
- QREs, Basic Research Payments, or Energy Research Payments.
- Regular and ASC.
- Elections: ASC and sec. 280C.
- Controlled group and groups under common control.
- Start-up company rules.
- In carrying on a trade or business.
- Loss and AMT companies.
- Pass throughs.
- Impact on other tax items, *e.g.*, foreign tax credits, domestic manufacturing deduction, and cost sharing agreements.



Claiming

How do you claim the R&D Credit?



R&D Tax Credit - Update

Approach

Phased Approach

- Phase 1 - Estimate benefit and cost to identify and support benefit.
- Phase 2 - Identify actual benefit.
- Phase 3 - Gather support for actual benefit.
- Phase 4 - Determine benefit available to report on financial statements.
- Phase 5 - Improve technologies and process to identify and support benefit.
- Phase 6 - Support benefit on examination/at appeals.



R&D Tax Credit - Update

Approach (cont'd)

Phase 1

- Estimate benefit
 - Obtain and review information and documents. Examples:
 - Tax year taxpayer expects to be able to use credit.
 - Other credits that must be used before the R&D credit.
 - If refunds are to be claimed, when statutes of limitations toll.
 - Exam history and current status.
 - Owners of taxpayer and their ownership interests.
 - Material acquisitions and dispositions of major portions of viable trades or businesses.
 - Tax returns - for federal and states with credit opportunities. Most states have R&D credits.
 - Org charts.
 - Documents describing product development process or software development methodology.
 - Accounting data for development projects/departments, including project-accounting and time-tracking reports, if available. For credit and base years.
 - Collaborative agreements funding projects; joint venture and cost-sharing agreements.
 - List of technical patents.
 - Contact info for leaders of business units involved in development process (“Tech Contacts”)



R&D Tax Credit - Update

Approach (cont'd)

Phase 1 (cont'd)

- Estimate benefit (cont'd)
 - Identify Tech Contacts to interview to:
 - Describe credit's potential benefit and plan to investigate it.
 - Request their input and support.
 - Outline eligibility conditions for qualified activities and costs.
 - Understand their organization's role in the development process.
 - Estimate QREs, BRPs, and ERPs.
 - Identify documentation, facts, and personnel available to identify and support qualified costs during Phase 2 ("Tech Contacts 2").
 - Discuss and agree to next steps.
 - Prepare for Tech Contacts interviews, *e.g.*, organize accounting and other info/documentation.
 - Interview Tech Contacts, singly or in groups.
 - Using qualified costs estimated by Tech Contacts, calculate the estimated:
 - Alternative Simplified Credits; and
 - Regular Credits, using the Minimum Base Amount for the credits generated by QREs.



R&D Tax Credit - Update

Approach (cont'd)

Phase 1 (cont'd)

- Estimate benefit (cont'd)
 - If the taxpayer is an Eligible Small Business, it can both:
 - Offset both regular and AMT tax liabilities for taxable years beginning in 2010; and
 - Carry back unused eligible small business credits five instead of just one year for the first tax year beginning in 2010.
 - An “Eligible Small Business” is a:
 - Corporation, the stock of which is not publicly traded;
 - Partnership; or
 - Sole proprietorshipwith average annual gross receipts of \$50 million or less for the three-taxable-year period prior to the tax year.



R&D Tax Credit - Update

Approach (cont'd)

Phase 1 (cont'd)

- Prepare workplan to identify and support benefit.
 - Identify opportunities and issues to be pursued and resolved:
 - All federal, state, and non-U.S. opportunities.
 - All tax years from which credits may be carried forward.
 - Refundable/transferable credits: *e.g.*, CT; MN; LA; IA; NE; HI / PA; NJ.
 - Exam history and current status.
 - Controlled and commonly-controlled group.
 - Base amount limitation and acquisitions and dispositions.
 - Funded research.
 - Substantiation for qualified research, qualified costs, and elements of base amount.
 - Identify resources needed, including consultants with R&D expertise/experience.
- Estimate cost to identify and support benefit.
- Calculate return on investment
 - Consultant fees are tax deductible.
- Determine whether and how to proceed to next phase.



R&D Tax Credit - Update

Approach (cont'd)

Phase 2 - Identify Actual Benefit - Implement Phase 2 Workplan

- Obtain and review detailed information and documentation for all relevant tax years. Examples:
 - Data/documentation to pursue and resolve opportunities and issues identified during Phase 1.
 - Eligible and total costs:
 - Chart of accounts.
 - If multiple accounting systems were used during relevant years, cross referencing mapping accounts from one system to another.
 - Project-accounting and time-tracking records, if available.
 - Taxable wages for all employees, including each employee's entity, business unit, cost center, job title, and work state affiliations, as well as employee IDs and start/end dates.
 - Forms W-3 and, if taxpayer isn't on a calendar year, Forms 940 and 941.
 - General-ledger detail for accounts with potentially-qualified supply and contractor expenses, including account and vendor numbers and descriptions.
 - Contracts with contractors who potentially performed qualified research.
- Request high-level employee/officer(s) to communicate purpose, benefit, and plan of R&D Project to Tech Contacts 2.



R&D Tax Credit - Update

Approach (cont'd)

Phase 2 - Identify Actual Benefit - Implement Phase 2 Workplan (cont'd)

- Prepare for interviews with Tech Contacts 2, *e.g.*, organize accounting and other data to facilitate efficient identification of qualified costs.
- Interview Tech Contacts 2 to:
 - Outline eligibility conditions for qualified activities and costs.
 - To reduce bias, describe activity types without reference to whether they qualify or not.
 - Review each employee, contractor, and supply cost, discussing with and obtaining from interviewees their judgment of the % of each that relates to each type of activity.
 - Take notes about what each did or was used for.
 - If project-accounting or time-tracking records exist, ask interviewees to validate them and/or identify which projects and the % of time relates to each type of activity.
 - Obtain %s needed to calculate the base amount.
 - Ask if any entities, business units, or cost centers not planned to be investigated were involved in the taxpayer's development process.
 - Recommended: obtain signed attestation or email confirming %s and how they were identified.
- Calculate qualified costs.
- Calculate Regular and Alternative Simplified Credits and state credits.



R&D Tax Credit - Update

Approach (cont'd)

Phase 2 - Identify Actual Benefit - Implement Phase 2 Workplan (cont'd)

- Calculate state credits.
 - Most states follow federal rules.
 - Important differences exist. Examples:
 - Where activities must be conducted: must be in state.
 - Definitions of qualified activities, qualified costs, and gross receipts.
 - Limitations on who can use the credit: sometimes only the corporation generating it may.
 - Permanent instead of temporary provision that has to be renewed periodically.
 - Carryback and carryforward periods differ, from none to indefinitely.
 - Limit to amount of credits state will allow each year.
 - Applications required before filing.
- Consider Non-U.S. R&D Benefits.

R&D Tax Credit - Update Approach (cont'd)

Phase 3 - Gather Support for Actual Benefit

- Analyze qualified costs to identify areas of potential exposure. Examples:
 - Qualified/total costs, for wages and supply and contractor expenses.

#	Department	Employee	Job Title	Gross Wages	W-2 Box 1	Qual. %	80% Rule	Qual. Wages	% of Total
1	R&D	Socrates	Chemist	144,000	120,000	90%	100%	120,000	1.2%
2	Product Development	Plato	Designer	120,000	100,000	80%	100%	100,000	1.0%
3	Manufacturing	Aristotle	Engineer	96,000	80,000	40%	40%	32,000	0.3%
4	Quality Assurance	Descartes	Technician	72,000	60,000	40%	40%	24,000	0.2%
5	Regulatory Affairs	Hegel	Director	84,000	70,000	25%	25%	17,500	0.2%
6	IT	Locke	Programmer	84,000	70,000	10%	10%	7,000	0.1%
...	<i>Etc.</i>	59,400,000	49,500,000	9,699,500	97.0%
Total				60,000,000	50,000,000			10,000,000	100.0%

- Sorting in descending order, *e.g.*, by dept, job title, supply. **Qual/Total Wages = 20%**

#	Job Title	Qual. Wages	% of Total	Job Title	Qual. Wages	% of Total
1	Chemist	1,200,000	12%	CEO	2,400,000	24%
2	VP R&D	800,000	8%	Chemist	1,200,000	12%
3	Designer	400,000	4%	VP R&D	800,000	8%
4	Engineer	400,000	4%	Designer	400,000	4%
5	Technician	200,000	2%	Engineer	400,000	4%
6	Director	200,000	2%	Technician	200,000	2%
6	Programmer	150,000	2%	Programmer	150,000	2%
...	<i>Etc.</i>	6,650,000	67%	<i>Etc.</i>	1,200,000	88%
Total				10,000,000	10,000,000	56%



R&D Tax Credit - Update

Approach (cont'd)

Phase 3 - Gather Support for Actual Benefit (cont'd)

- Develop workplan based on areas of potential exposure.
 - Areas revealed by analytics.
 - High-level employees.
 - Indirect and mixed-service cost centers.
 - Lack of nexus between qualified costs and business components/projects.
 - Estimates and extrapolations.
 - Lack of documentation/substantiation, *e.g.*, for:
 - Base amount.
 - Qualified activities.
- Implement workplan to reduce/eliminate exposure areas.
 - Interview Tech Contacts 2 to obtain documentation and information regarding:
 - High-level employees, *e.g.*, calendars, meeting minutes, emails.
 - Job descriptions.
 - Qualified activities for credit years.
 - Draft descriptions of qualified activities and how they meet the four-part test.

R&D Tax Credit - Update

Approach (cont'd)

Phase 3 - Gather Support for Actual Benefit (cont'd)

- Principle 1 for documenting qualified activities: process of experimentation.

FACTS		LAW		DOCUMENTATION
Development Process	→	Process of Experimentation ("POE")	←	Typical Documents (See Next Slide)
1. Design Requirements	→	1. Business component / Permitted purpose	←	1. Design Requirement documents
2. Design Specifications	→	2. POE and uncertainty	←	2. Functional / Logical Design Specs
3. Prototyping, Programming, Modeling	→	3. POE	←	3. Drawings
4. Testing	→	4. POE and technological in nature	←	4. Test plans, test results
5. Redesign and Retesting	→	5. POE and uncertainty	←	5. Revised drawings, test plans and results

R&D Tax Credit - Update

Approach (cont'd)

Phase 3 - Gather Support for Actual Benefit (cont'd)

- Principle 1 for documenting qualified activities: process of experimentation. (cont'd)

STAGES OF DEVELOPMENT PROCESS / ELEMENTS OF PROCESS OF EXPERIMENTATION						
Department	Design Requirements	Design Specs	Prototyping/ Modeling	Testing	Redesign/ Retesting	Production
Marketing	x	x				
Concept and Feasibility	x	x	x			
R&D	x	x	x	x	x	
Engineering	x	x	x	x	x	
Manufacturing Engineering		x				x
Manufacturing				x	x	x
Quality Assurance				x	x	x
Field Engineering					x	
Customer Service					x	
Administration		x				
<i>Etc.</i>						



R&D Tax Credit - Update

Approach (cont'd)

Phase 3 - Gather Support for Actual Benefit (cont'd)

- Principle 2 for documenting qualified activities: contemporaneous documentation. (cont'd)
 - Patents.
 - Test plans & results.
 - White papers.
 - Board presentations.
 - e-mails.
 - Lab notebooks.
 - Work plans.
 - Design specifications.
 - Consulting agreements.
 - Schematics, diagrams or charts.
 - Testing documents or images.
 - Engineering notes or sketches.
 - Logs innovation/new products.
 - Meeting minutes about, *e.g.*:
 - Process improvement discussions.
 - Lean manufacturing.
 - New product development.
 - Product recall/irregular activities.



R&D Tax Credit - Update

Approach (cont'd)

Phase 4 - Determine Financial Statement Benefit - FIN 48 / ASC Topic 740

- Determine basis of analysis
- Determine units of account. Examples:
 - Projects.
 - Cost centers/departments.
 - Activities.
 - Job titles.
 - Contractors or contracts.
- Recognize units more likely than not to be sustained on exam.
- Measure benefit.
 - Documentation: inadequate or poor documentation may cause the amount ultimately to be realized upon exam to be less than the amount permitted to be recognized on the merits of the tax law.



R&D Tax Credit - Update

Approach (cont'd)

Phase 5 - Improve Technologies and Process to Identify and Support Benefit

- Leverage development process.
- Accounting systems.
- Documentation systems.



R&D Tax Credit - Update

Approach (cont'd)

Phase 6 - Support Benefit On Examination/At Appeals

- Even after statute of limitations tolls, IRS may determine additional federal income tax deficiencies after statute to offset additional R&D claims. *R.H. Donelley*.
- Lack of documentation/substantiation.
 - Estimates and extrapolations.
 - Oral testimony. *Cohan, Fudim, McFerrin, Union Carbide, Trinity*.
- Tier One issue.
- Nexus between qualified costs and business components/projects.
- Penalties.
- IRS-BDO-and-Other-Accounting-Firms Meetings:
 - Aug. 2010 - what constitutes an “acceptable R&D study.”
 - Jan. 2011 - nexus issue.
 - Ongoing - attempting to co-develop guidelines for examiners.



R&D Tax Credit - Update

Approach (cont'd)

Phase 6 - Support Benefit On Examination/At Appeals

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 - Jan. 2011 - nexus issue.



Other Considerations

What else should you know?



R&D Tax Credit - Update

Next Steps

- **Pennsylvania application process** - taxpayers must:
 - Incur qualified Pennsylvania R&D expenses in the current tax year and in at least one preceding tax year.
 - Such expenses cannot have been incurred in Pennsylvania but not in a Keystone Opportunity Zone.
 - Incur qualified Pennsylvania R&D expenses
 - Submit an application to the Department of Revenue by Sep. 15.
 - Including a statement signed by a corporate officer and declaring that “this return, including any accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct and complete.”
 - Visit www.newpa.com.
 - The Department has until Dec. 15th to notify taxpayers of their approved tax credit amount.
- **Federal elections:** ASC and sec. 280C.
- **Pass throughs.**
- **Loss and AMT companies.**
- **Controlled group and groups under common control.**

BDO Contacts – R&D Tax Services

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Thank You.

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