

Black Line Group

The R&D Tax Credit

helping keep your bottom line in the black

keeping your
bottom line **in the BLACK**
with the R&D Tax Credit

The Difference between a
Tax credit vs. Tax Deduction

Tax Credit



Credit = dollar for dollar
reduction in the amount of
taxes paid

Tax Deduction



Deduction = income on
which you do not pay tax

What is the R&D Tax Credit?

- **A tax incentive provided by the U.S. government to encourage businesses to invest in activities within the U.S. that will provide for product and process improvements and/or the introduction of new products or processes**

Applicable to C-Corps, S-Corps, LLC's Partnerships, Sole Proprietorships and Joint Ventures



History of the R&D Tax Credit

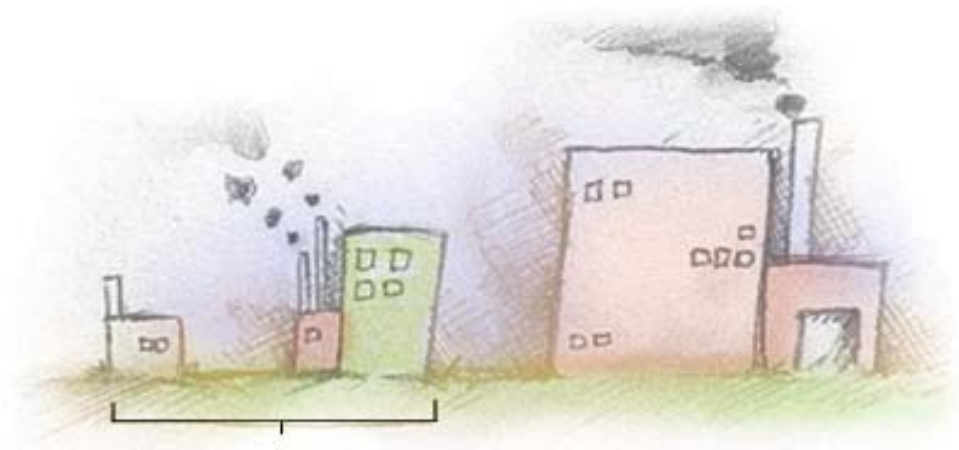
- R&D Tax Credit has a history over 28 years
- Used by the majority of Fortune 1000 companies
- Much legislative activity



The tax credit is a valid tax planning opportunity which is permitted under IRC §41 and §174.

An opportunity there for the asking

It is estimated that the amount of credits has risen to \$7 billion with the renewal of the credit several years ago



[1] The Joint Committee on Taxation in October of 2007

Where is the R&D?

- **Qualified R&D spending takes place in many areas within a business, not just an R&D or Engineering department**



Get credit for your
investment in your business

- **R&D spending includes:**
 - Internal labor (i.e. salaries, wages, bonus)
 - Direct research
 - Direct **supervision** of research
 - Direct **support** of research
 - Supply costs (prototype costs, lab supplies, etc)
 - External labor (contractor payments) if:
 - Payment is contingent on success (fixed price)
 - Rights are retained as to the R&D



Activities that are R&D Friendly

- **To qualify as a legitimate R&D activity, it must be:**
 - Conducted for a permitted purpose
 - Intended to resolve technological uncertainties
 - Involve a process of experimentation
 - Use a permitted science



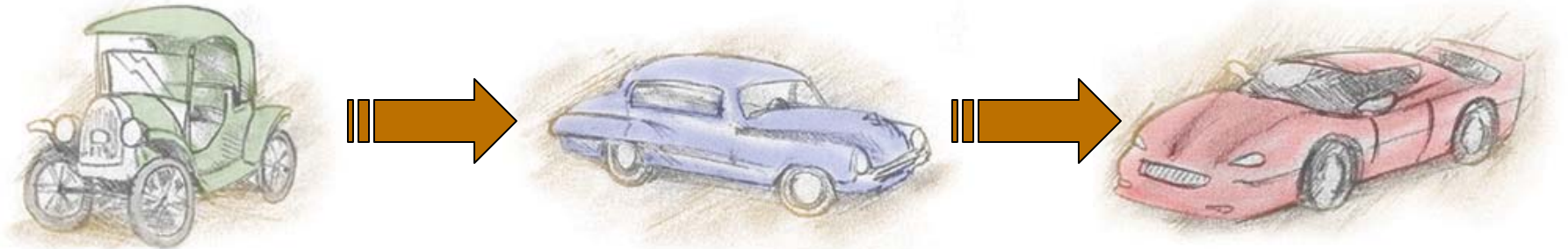
Any new OR improved product, process or software development initiative has potential for R&D tax credit qualification

1st R&D Test for Qualification

Permitted Purpose Test:

“What is the goal of this project?”

EVOLUTIONARY DEVELOPMENT



2nd R&D Test for Qualification

Technological Uncertainty Test:

“What is not known at the outset of the project?”



3rd R&D Test for Qualification

Process of Experimentation Test:

“What was done to eliminate the uncertainties?”

FAILURE IS REWARDED



4th R&D Test for Qualification

Technological in Nature Test:

“What science is being relied upon
as you perform the activity?”



Metal Stamping / Molding Manufacturer

\$166,000+ Tax Credits Identified for 2008

\$995,000+ Total Tax Credits Identified

- **Goal-** To develop a process that allowed for the in-line weldment of an electrical resistor to a stamped component
- **Technical uncertainty-** The company was technically challenged with designing and fabricating equipment to automatically advance and weld an electrical resistor to a stamped metal component. Further, the process was to include the inspection or verification of the weld via electrical and mechanical means
- **Experimentation-** They evaluated alternate designs for the test equipment, specifically: a) electrical testing of the weld versus a destructive test. b) Using cameras to detect flaws in the weld which would accept/reject the weld/part c) Using a camera to verify location of weld which could also determine if the weld/part is acceptable

Precision Tooling / Custom Injection Molding

- **Goal** - To develop a process of machining intricate geometry coordinated within a mold frame by testing melt flow patterns for engineering grade resin blends that eliminate warp of an injection molded component
- **Technical uncertainty** – Engineering CAD/CAM models for melt flow analysis testing that identify the variables in processing parameters for resin blends from a viscous state to a solid within very close tolerances of form, fit, and function
- **Experimentation** – The company investigated and created digital simulation patterns of flow characteristics based on multiple variables that respond differently in specific conditions. The optimum process is identified through trial of: fill patterns, pressures, temperatures, geometry, flow rate, thermal stress, and conformity

Precision Machining and Assembly

\$19,000+ Tax Credits Identified

- **Goal-** To design a high capacity lift that would function properly and be reliable while meeting cost requirements
- **Technical uncertainty-** Could engineers design a low profile lift as well as discover the appropriate lift solution? Could they design the lift with reliable and durable bearings?
- **Experimentation-** Technical personnel evaluated several alternative to meet the functionality requirements including various hydraulic lift solutions, scissor lifts, and air bags to create the lift. They also created several low profile designs to fulfill the customer requirements

Plastic Injection Mold Manufacturer

\$380,000+ Fed & State Tax Credits Identified

- **Goal-** To create a new medical syringe with high precision tolerances
- **Technical uncertainty-** Whether they would be capable of meeting cost constraints and how to prevent irregular shrinkage during the injection mold process
- **Experimentation-** To account for irregular shrinkage and to meet cost constraints, they experimented with alternative core pins, core angles, and plastic feeding systems

Injection mold tooling designer and manufacturer

\$20,000+ Tax Credits Identified

- **Goal-** To design production molds capable of creating tight tolerance components in high temperature conditions
- **Technical uncertainty-** Could engineers design the molds within the tolerances? Could they mold parts to a tolerance of +/- .0005 at multiple locations while meeting cost targets?
- **Experimentation-** Technical personnel developed and evaluated chrome, Teflon, and bronze plating to determine the material which would create the most functional molds. They also evaluated manufacturing techniques to determine the most appropriate method that would hold wall thickness

Precision Plastic Mold Manufacturer

\$150,000+ Tax Credits Identified

- **Goal-** To develop a mold for a plus-sized clear plastic chair
- **Technical uncertainty-** The company was technically challenged with designing the mold gates and ejector mechanisms without compromising the quality of the chair
- **Experimentation-** The company evaluated alternative locations for the gates, including the top and bottom versus the middle. They also evaluated ejection slides, single action ejection and dual action ejector strokes until they discovered the best solution

If you can answer **YES** to these....

- Do you have an R&D, product development or design department?
- Do you provide design, engineering, or testing services to your customers?
- Are you a software development company or in the business of manufacturing a product?
- Have you recently applied for and/or received patents?



Examples of “Qualifying Activities”

- Develop new, improved or more reliable products, processes or formulas
- Develop prototypes and models including computer generated models
- Design tools, jigs, molds and dies
- Develop or apply for patents
- Perform certification testing
- Conduct testing of new concepts and technology
- Develop new technology
- Attempt using new materials
- Perform environmental testing
- Add new equipment
- Automate/streamline production process or manufacturing process
- Develop software or hardware
- Improve or build new manufacturing facilities

Maximizing the R&D Tax Credit

Who has the expertise to maximize the R&D tax credit?

- Calculation vs. Study Approach
 - Educate company/employees about definition of R&D
 - Identify ALL Amounts for the Form 6765
 - Documentation of the activities and costs that go onto the Form 6765
- Most CPAs choose not to specialize in the R&D Tax Credit area
- Boutique R&D Firms Partnering with your existing CPA
- Keep your CPA involved

What We Need To Determine

If the company can generate a meaningful R&D Tax Credit

- Amount of “qualified spending”
- Base-period spending

If and when the credits can be used

- AMT
- Number of shareholders

Can you document your Qualified Research Expenditures

Legislative Guidance

LEGISLATION:

- Credit has always been included in temporary tax bills and has been extended 13 times since 1981
- H.R. 1424: On 10/3/08, Congress approved legislation that contained a two-year, retroactive renewal of the research tax credit. Currently R&D tax credit is available until December 31, 2009
- Current proposal to make the R&D Tax Credit permanent

REGULATIONS:

- Final regulations were issued in December 2003

Tax Credit Computation Options

Two calculation alternatives:

- Regular Research Credit
 - Compare current year spending to a base line of historical spending, often 1984-1988
 - Often the most lucrative
- Alternative Simplified Credit
 - Newest calculation option
 - Compare current year spending to prior three years
 - Strengthened in 2009

Will filing an R&D Tax Credit trigger a tax audit?

Filing an amended return for an R&D Tax Credit does not automatically trigger an audit.

IRS has made the R&D Tax Credit a “Tier One” Issue

Exception: If you have a credit in excess of \$1 million



**“Audit Technique Guide for Research Credit Claims”
issued in May 2008**

- Establish nexus between QREs and QRAs
- Implement a project tracking approach to support the wages associated with R&D
- Track supply costs by project for expenses which are consumed or “used up” during the development process (at a minimum place into an account designated specifically for R&D expenses)
- Document the development process not just the end result

What Documentation Is Necessary To Sustain A Credit?

Retain research activity documentation, such as:

- Email Communications which show failures, problems, or concerns encountered during the development
- Product or Project Specifications, Descriptions, or Proposals
- Technical Reports / Test Reports and Results
- Documentation of alternative supplies/materials/technology evaluated
- Project Diagrams/Drawings/Pictures including older versions and conceptual drawings which differ from the final product
- Issue Logs / Meeting Minutes /Flowcharts or Time Schedules / Schedules of Releases
- Patent Applications or Abstracts
- Contractual Agreements with Consultants and Customers

Reading The Small Print

- Determination of “open” years for amended R&D tax credits is contingent on usability of the credit (GBC rules)
- R&D Credits can not reduce federal tax below the TMT
- Credits can be carried back 1 year and carried forward 20 years



Action Steps

1. At a minimum, evaluate the R&D Tax Credit opportunity for the current tax year
2. Evaluate whether it makes sense to go back to prior years
 - Can tax credits be used?
 - Can the claim be adequately documented?
3. Put in place a methodology/process for utilizing the R&D Tax Credit going forward

The Bottom Line...

1. Substantial R&D tax credit savings going unclaimed
2. This is a valid tax planning opportunity – NOT a tax shelter
3. Even if you are claiming the R&D tax credit, you may be leaving dollars on the table
4. Document QRE's and QRA's while doing the R&D activity, not retrospectively

THANK YOU

Don't hesitate to contact us after the seminar with any additional questions

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