

“Incentives for Research and Development”

Does your company design and develop new products or processes? Is there uncertainty at the outset of the project? If you answered yes to these questions, you may qualify for some substantial federal and state tax credits. These credits will reduce dollar for dollar your income tax liability.

Basically, the federal credit is equal to 20% of the qualified research expenditures for the current year in excess of a base amount. The company's deduction for expenses related to R&D must be reduced by the amount of the credit, unless the company elects to take a credit of 13%, rather than 20%.

In order to qualify for the credit, the research activity must be undertaken for the purpose of discovering information that is **technological in nature** and is paid in connection with carrying out the trade or business of the taxpayer. Furthermore, the research must be conducted utilizing a process of **experimentation**.

In December of 2003 final regulations were released. This new guidance significantly expands the expenditures that qualify for the credits and provides us with greater opportunities in this area. As part of these final regulations the process of experimentation was more clearly defined. These requirements are:

1. The process must **evaluate** at least one alternative.
2. There must be **uncertainty** related to the result or outcome.
3. The process of experimentation must rely on **fundamental principles of the physical or biological sciences, engineering or computer science** to resolve the uncertainty.
4. Methodologies may involve **modeling, simulation or systematic trial and error**.

Qualified research and experimentation expenditures include taxable wages for qualified services performed in support of the research, the amount paid for supplies used in the conduct of the qualified research and 65% of all contracted research expenses. The key is identifying eligible research wages. It is not unusual for engineers and top level management to spend substantial time in direct services and supervision of research projects. The research has to be conducted in the United States before the commercial introduction of a product on the market and it cannot involve style, taste, cosmetic design, or seasonal design factors.

Many activities that you are currently performing within your company simply to maintain a competitive edge may in fact qualify for this credit. The following is a listing of some types of activities where this opportunity for substantial tax credits may occur:

1. Develop new, improved or more reliable products, processes or formulas,
2. Design tools, jigs, molds and dies,

3. Develop or apply for patents,
4. Streamline or automate internal processes,
5. Develop new technology,
6. Utilize new materials in your manufactured product,
7. Develop or upgrade production control or systems software
8. Perform environmental or certification testing,
9. Develop models or prototypes,
10. Add new equipment or build or improve a new manufacturing facility, and/or
11. Contract with outside consultants to perform any of these above listed activities.

While under current law this credit is scheduled to expire at the end of this year, there is a current proposal, entitled the "Investment in America Act of 2005" that would permanently extend the credit. It would also add an "elective alternative simplified credit" based on 12% of the increase in expenditures for research, with the basis being the average research expenditures of the prior three years.

The Commonwealth of Pennsylvania also provides Research and Development tax credit incentives; however the state establishes in advance the maximum amount of credits that will be granted annually. In 2004 and 2005 this limit is \$30,000,000, of which \$6,000,000 is carved out for small business. Historically, small businesses have not requested the full \$6,000,000 and therefore have received 100% of their requested calculated credit. For purposes of this credit a small business is defined as companies with less than \$5,000,000 in net book assets.

The credit itself is calculated by averaging the previous four years of R&D expenditures and computing 50% of the current year's expenditures. Whichever is greater is subtracted from the current year's R&D expenses. The credit is 10% of the remaining balance. Fortunately, Pennsylvania uses the federal rules for determining the eligibility of research expenditures, with the exception that the expenses must be incurred within the state of Pennsylvania. The credit can be applied against the company's PA corporate net income tax or PA capital stock/franchise tax, or the credit can be passed through to shareholders or partners in a pass-through entity to use against their personal income tax liability. A unique feature of the Pennsylvania tax credit is that taxpayers, primarily start-up companies with minimal tax liabilities, can apply to the Department of Community and Economic Development to sell or assign their credits if there has been no allowance filed within one year from the date the credit was approved.

If your company does engage in R&D activities, make sure that you are receiving the tax incentives that are available to give your company the additional reward that it deserves.

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Editor's note --- This article is derived from a presentation that Karen recently made in Erie, Ridgeway and Hermitage to manufacturing companies.

