

Q&A: What You Don't Know About R&D Tax Credits

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Manufacturers may not be taking full advantage of research and development federal tax credits. Our sister publication, *Manufacturing Business Technology*, took a moment to ask Michael Devereux II, CPA — director of Manufacturing & Distribution Services for Mueller Prost PC and a speaker at the upcoming [Distribution and Manufacturing Profitability Forum](#) [1] — to clarify some of the details surrounding R&D tax credits.

Manufacturing Business Technology: You'll be talking about research and development tax credits for manufacturers at the Distribution & Manufacturing Profitability Forum, suggesting that it is one of the most overlooked tax savings opportunities in the U.S. Why do you think manufacturers aren't taking advantage of these opportunities?

Michael Devereux: I think it's a misnomer as to what qualifies for the credit. Frequently we find that companies think that they need to be doing things that are revolutionary to their industry. In other words, they believe that they might have to expand, exceed or refine the knowledge in their industry, but that's a narrower definition of what the Internal Revenue Service code defines.

The federal credit rewards companies anytime they are developing or improving their products and processes that are technological in nature. That is, they don't need to be expanding the knowledge. In fact, the treasury regulations say that they're allowed to rely upon existing engineering principles in order to solve for design uncertainty. So as long as they're solving for that design uncertainty through some sort of modeling or systematic trial and error — that's a qualified research activity.

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There can be seven people in my industry, where six of them have all figured out how to design a product. If I'm number seven and I have to go through some experimentation to catch up to others in my industry — that could qualify as research. The R&D doesn't need to be revolutionary, it can be evolutionary. Say I'm trying to improve functionality, reliability or performance of my products or processes — then that's qualified research. Most people don't see that as R&D, so it's missed many times.

MBT: What are some of the biggest obstacles manufacturers should be prepared for in the process?

MD: The reason the credit exists is to get companies to invest in innovation of new product development and create engineering and scientific-based jobs here in the U.S. The hurdles manufacturers have to overcome are understanding what qualifies for the credit.

There are a number of requirements, some of which are called out in treasury regulations that you would otherwise think could qualify for the credit that don't. For instance, research outside the U.S., research after commercial production or duplication of an existing business component. Those things don't qualify for the credit. Having that understanding is very important.

In addition, documentation is key to claiming this credit. Documenting for the credit properly can really make or break a research credit claim. And you have to document it in two different manners.

First, you have to prove that research is taking place. So you have to have qualitative documentation. That is, you've got to have documentation that shows that you were engaging in a specific experimentation. So designs, drawings, results of tests, emails, meeting minutes from design review meetings — those are all things that help tell the story of the activities that employees engaged in that would meet the definition of qualified research.

Once you've proven that research is taking place, you've got to quantify it. You've got to be able to document the number of hours or other percentage of time that employees spend working on research. You've got to be able to document the material costs that are used in the conduction of research — or payments to third parties for the performance of research on your behalf.

Gathering those expenditures and substantiating them is really the crux of documenting the credit. Companies have to tie the employees' activities to the expenditures. So manufacturers have to show that John Smith is performing research. One of the best ways to do that is to look for emails, signoffs, logins and logouts of CAD and CAM systems and the like. Those sort of things are smoking guns that employees were engaged in research.

MBT: Without giving too much away, what can manufacturers expect to learn about during your session at the Distribution and Manufacturing Profitability Forum?

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MD: They'll learn about what qualifies for the credit, not just the activities that qualify, but what expenditures qualify. They'll learn what type of material costs qualify — and that can be substantial especially for custom manufacturers. We just had treasury regulations that were issued in September that greatly expand upon the eligible expenditures that are defined as research and experimental.

Manufacturers will understand what is necessary to be able to claim the credit in prior years. It's not just 2014 and beyond, companies can go back and request refunds. I've got some clients that are \$20 million manufacturers that are claiming \$150,000 of dollar for dollar credit against tax liabilities. These savings can be substantial.

For more information and to register for the Distribution and Manufacturing Profitability Forum, please visit www.distributionmanufacturingforum.com [1].

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[1] <http://www.distributionmanufacturingforum.com/>