R&D Tax Credits

Moss Adams Symposium
September 29, 2011
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AGENDA

• Introduction to the Credit
• Legislative Update
• Industry Opportunities
• Recent Case Law
• State Credits
Introduction to the Credit
HISTORY OF THE CREDIT

• Introduced in 1981
• Enacted to promote technological advancements in lieu of emerging technologies from Germany and Japan
• Renewed through December 31, 2011
• New Alternative Simplified Credit for 2007 through 2011
• Several new court cases released during 2008–2011 that help to further clarify specific issues
POTENTIAL BENEFITS

• Significant federal tax savings – for every dollar deemed as a qualified expense, roughly 6.5% can be captured as net credit

• Significant state tax savings – many states offer lucrative research credit incentives that can be claimed on top of federal benefits
RISKS

• Federal Priority – “Tier 1 Directive”
  o Highly contentious – high probability for examination by tax authority
  o Must provide substantial support for credit claim

• State Examinations
  o Subject to examination by state tax authority
  o Must provide substantial support for credit claim

• Nexus & Documentation
  o Linking qualified expenses to qualified activities is critical
  o IRS wants contemporaneous documentation
THE FOUR-PART TEST

1. Technical Uncertainty
2. Process of Experimentation
3. Technological in Nature
4. Permitted Purpose
QUALIFIED EXPENDITURES

- Wages
- Supplies
- Contract Research

- Assuming no base threshold limitations, the federal credit can be 6.5% of qualified expenditures
OTHER CONSIDERATIONS

• Credit Usability
  o Taxable income
  o Alternative Minimum Tax (AMT) limitations
  o Credit carries back one year and forward 20 years
  o New law allows for small businesses to carry back 5 years and offset AMT for credits generated in 2010

• Funded Research
  o Contract analysis to determine rights and risks

• Foreign Research
  o Research performed outside of the U.S. is excluded
SECTION 280C ELECTION

- Final Regulations issued on July 27, 2011
- Section 280C election eliminates impact of double tax benefit – current expense deduction for refunded taxes
- Must be made on an originally filed return
- Generally favorable to make a 280C election for federal credit but not necessarily for California credit
  - Not making a 280C election for California can result in a greater net benefit as a portion of the “add back” income is apportioned outside of California
Legislative Update
12/17/10: President signed into law the Tax Relief, Unemployment Insurance (UI) Reauthorization, and Jobs Creation Act (H.R. 4853) – extending the research credit for two years:

- Research credit is extended in its present form, i.e., Alternative Simplified Credit at 14% and a Traditional Research Credit at 20%
- Research credit will be extended retroactively back to 1/1/10 through 12/31/11
SMALL BUSINESS TAX ACT

• Small Business Tax Act (signed by the President on 9/27/10) provides special benefits for small businesses who claim research credits

• Five year carryback of general business credit of eligible small businesses
  o Stock is not publicly traded
  o Average annual gross receipts for the past three taxable years does not exceed $50 million
  o Under this new law, small businesses can:
    ▪ Utilize 2010 research credits to offset AMT liability (regardless of whether the credit generated in 2010 is actually utilized in 2010 or is carried back or carried forward to another taxable year), and
    ▪ Carry back research credits for 5 years or carry forward for 20 years
Recent Case Law
PROCTOR & GAMBLE V. U.S., 1:08 CV 00608 (6/25/10)

• Court found that intercompany sales should not be included as a component of Gross Receipts, affirming and preserving the Tax Credit’s substantial benefits and incentives for innovation to the taxpayer.

• Since the P&G case was decided, the IRS has conceded this issue in other cases in litigation and has recently allowed 100% exclusion of CFC gross receipts.

• *Hewlett-Packard Co. v. Commissioner*, No. 21976-07
  - July 8, 2010: Hewlett-Packard files a motion for partial summary judgment.
  - September 7, 2010: Commissioner filed its notice of no objection to the motion on the intercompany gross receipts issue.
Two primary issues

- Uncertainty
  - Tax Court ruled that a taxpayer does not have to be uncertain that the project would be successful
  - Uncertainty can be established if the information available to the taxpayer did not establish the appropriate design of the product

- Base Period
  - Estimates of expenses may be utilized to establish base period information if reliable documentation and estimates are used
TG MISSOURI, 133 T.C. NO. 13 (11/12/09)

- TG Missouri Corp (TGM) treated the cost of the production molds it sold to customers as QREs for “supplies.”
- The sole issue addressed by Tax Court was whether the production molds were assets of a character subject to allowance for depreciation and thus not QRES – because 41 and 174 excludes such costs.
- Production molds were not assets of a character subject to the allowance for depreciation because TGM would not suffer an economic loss resulting from deterioration and exhaustion of the molds produced for sale.
TRINITY INDUSTRIES, NO. 3:06-CV-00726

- Ship builder claimed all development costs for six “first-in-class” ships
- Court concluded 100% of the supplies and construction labor for two of the ships qualified
- Court accepted “integration risk” as a qualified research activity, i.e., integrating commercially available components in designing a first-in-class ship.

Additional Issues
- Lack of documentation supporting qualified activities or related expenses.
- Costs included in the calculation that are generally considered overhead, i.e., painting, sanding, etc.

Resolution
- If records do not exist, court must approach the project with and “all or nothing” methodology. Also referred to as “substantially all” in the R&D regulations.
- If the entire ship does not meet the 80% substantially all test, none of the expenses are eligible.
- 2 of the 6 ships met the 80% test; therefore, all costs related are included as an R&D expense.
- The remaining 4 ships had qualified components, but no expenses were includable because the taxpayer did not have sufficient records available to specifically identify such components.
FEDEX V. U.S., W.D. TENN. 2009

• No final regulations defining what constitutes internal use software (IUS)
• The district court held that the taxpayer could rely on the withdrawn 2001 Regulation IUS High Threshold of Innovation Standard
• Taxpayer did not have to also apply the restrictive discovery test also contained in the 2001 Regulations
RECENT EXAM EXPERIENCE

• Field experience
• May have to go to appeals if you get a bad answer in the field
  ▪ Example – 100% credit disallowance in field – 75% credit sustention at appeals
  ▪ Clients who go to appeals generally settle in the 30%–70% sustention of credits
RECENT EXAM EXPERIENCE

• Most frequent issues:
  o Fixed-base percentage
  o Documentation
    ▪ Taxpayers rely on books and records under Tres. Reg. 1.6001-1(a) to quantify and document research credits
    ▪ IRS targets the use of estimates in computing credits as well as base period QREs and gross receipts as a means for denying credit claims
    ▪ Courts continue to rule in taxpayers favor regarding the use of estimates and employee testimony (McFerrin and Union Carbide)
RECENT EXAM EXPERIENCE

- Nexus
  - IRS has aggressively challenged research credit claims citing a lack of nexus between business components and QREs
  - Lack of project accounting
  - Project accounting is not required by statute
    - Cost center accounting has been accepted by the IRS for many years
    - Other common issues:
      - High wage executives/Indirect Supervision
      - Support Departments
      - Job Titles
Industry Opportunity Areas
INDUSTRY OPPORTUNITY AREAS

• Engineering and Construction
• Forest Products
• Food Processors
• Toy Manufacturers
• Boat Builders
• Aerospace Component Manufacturers
• Injection Molding Companies
• Printing/Label Companies
• Automated Machinery
• Footwear
• Apparel
## HOW MUCH CAN YOU SAVE?

<table>
<thead>
<tr>
<th>Case Studies</th>
<th>Company Annual Revenue</th>
<th>Total Taxes Saved With R&amp;D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nutritional Supplement Manufacturer</td>
<td>$20,000,000</td>
<td>$125,000</td>
</tr>
<tr>
<td>Boat Builder</td>
<td>$10,000,000</td>
<td>$105,000</td>
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<tr>
<td>Electronics Manufacturer</td>
<td>$2,700,000</td>
<td>$229,000</td>
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<tr>
<td>Aerospace Subcontractor</td>
<td>$30,000,000</td>
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<tr>
<td>Food Processor</td>
<td>$22,000,000</td>
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<tr>
<td>Software Designer</td>
<td>$100,000,000</td>
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<tr>
<td>Specialty Equipment Developer</td>
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<td>Agriculture</td>
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<td>$240,000</td>
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<td>Vineyard/Winery</td>
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<td>$165,000</td>
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<tr>
<td>Footwear Designer</td>
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<tr>
<td>Apparel</td>
<td>$85,000,000</td>
<td>$120,000</td>
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<tr>
<td>Engineering and Construction</td>
<td>$250,000,000</td>
<td>$450,000</td>
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PROFILE OF AN R&D CREDIT BENEFICIARY COMPANY

- Develops and manufactures new products
- Patents – intellectual property
- Expends significant resources on developing new software
- Implements new manufacturing processes/plant improvements
PROFILE OF AN ASC BENEFICIARY COMPANY

- Currently reporting no research credits due to base limitations
- Currently have limited credit opportunities due to increasing gross receipts
- Have undertaken a large research effort in 2010 and planning to undertake a large research effort in 2011 (relative to research spending in prior years.)
- Have difficulty determining ‘regular’ base amount due to lack of substantiation from the 1984-1988 period
- Smaller companies that cannot justify the compliance cost of reconstructing historic data from the 1984-1988 period
State Research Credits
STATE RESEARCH CREDITS

• No state has adopted the Alternative Simplified Credit, but:
  ▪ Alaska, Vermont, and Nebraska allow a portion of federal credit on state level
  ▪ Hawaii uses federal credit as starting point for calculation of credit
  ▪ Oregon allows use of ASC base amount
• Many state research credits are permanent – including California and Massachusetts
• While a few states have pending bills to expand research incentives, major changes are unlikely
CALIFORNIA RESEARCH CREDIT

- Only R&D expenses within California
- Permanent credit
- Credit equal to 15% of the gross credit
- S-Corp
  - 2 levels of credit
    - 1/3 at the S-Corp level
    - Pass through to shareholders
    - Open tax years – generally 4 years
    - Credit carries forward indefinitely
QUESTIONS?

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