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THE R&D TAX CREDIT

Driving American Innovation & Job Creation

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THE R&D TAX CREDIT:

A Catalyst for Business

A lot has happened in the last two decades for U.S. businesses. From elections to tax reform to shifts in the global economy, more and more businesses have had to evolve and adapt their strategy within their respective industry to remain competitive. While the changes have been mixed depending on who you are and what you do, one thing that improved across all industries is the R&D Tax Credit – **the largest tax credit available for U.S. businesses.**

Established in 1981, the R&D Tax Credit rewards companies for improving a product, process, formula, invention, software or technique, offering additional tax savings to those companies that are thinking bigger and better about their products or services. Originally designed to encourage everyday innovation among U.S. businesses and to keep high-paying jobs in the United States, the reach of the R&D Tax Credit has expanded over the years, as demonstrated by the recent IRS data. After the passing of the PATH Act in 2015, the R&D Tax Credit is now a permanent fixture of the United States tax code, and one of the most lucrative credits available to businesses of all sizes.

According to data recently released by the IRS, 16,624 corporations across numerous industries claimed the R&D Tax Credit in 2013, receiving over $11.2 billion in federal tax credits. On an individual basis, the average credit claimed by corporations was $673,724. Keep in mind that this data does not include credits claimed by pass-through entities such as S-corps and LLCs, which are both major beneficiaries.

Note: [1] https://www.irs.gov/statistics/soi-tax-stats-corporation-research-credit

DID YOU KNOW?

Software and IT companies can qualify for the R&D Tax Credit, and are among the fastest growing industries claiming more in credits year over year.

EVOLUTION OF THE R&D TAX CREDIT

1981

In response to a perceived economic slowdown and job outsourcing becoming more commonplace, **1981 marked the original enactment of the federal R&D Tax Credit.** The credit was developed to reward American businesses for keeping technical jobs within the country as well as driving innovation within their industry. Activities for qualifying for the credit were limited to creating or producing a product or process that was new to the world according to what was referred to as the "Discovery Rule". The definition of research was defined under Sec. 174 to exclude only foreign research, social sciences and funded research limiting the amount of industries that could take advantage of the credit, only a very small percentage of companies were able to qualify.

2001

Initially proposed in 2001, and later finalized in 2003, were **the regulations to eliminate the "Discovery Rule" from the qualification requirements for the R&D Tax Credit.** This regulation change was beneficial to businesses as it altered what activities could now qualify for the credit. Activities that previously could not qualify for the credit due to not being "new to the world", could now qualify as long as the activities were "new to the taxpayer" which opened the door for new industries to start taking advantage of the credit.

2006

In 2006 **the Alternative Simplified Credit (ASC) is enacted,** providing additional flexibility to businesses in calculating credit amounts.

2013

First proposed in 2013, **Section 174 regulation** changed the way controlled group credits are allocated amongst members. Later finalizing in 2014, Section 174 regulations put into effect that if supply costs are incurred for the development of a pilot model, the ultimate disposition of the pilot model is irrelevant. Additionally, temporary regulations allowed ASC on amended returns for years in which a taxpayer had not previously claimed a credit.

2015

The end of 2015 marked the passing of the **Protecting Americans from Tax Hikes Act (the PATH Act) that officially made the R&D Tax Credit a permanent** addition to the U.S. tax code. Additionally, AMT (Alternative Minimum Tax) turn off was enacted for businesses with $50 million or less in gross receipts allowing for more businesses than ever before to take advantage of the incentive.

2018

Tax reform legislation is implemented and **the R&D Tax Credit remains one of the most lucrative tax incentives for U.S. businesses.**

Sources: Internal Revenue Code Section 41 & Section 174 regulation. Protecting Americans From Tax Hikes Act of 2015.

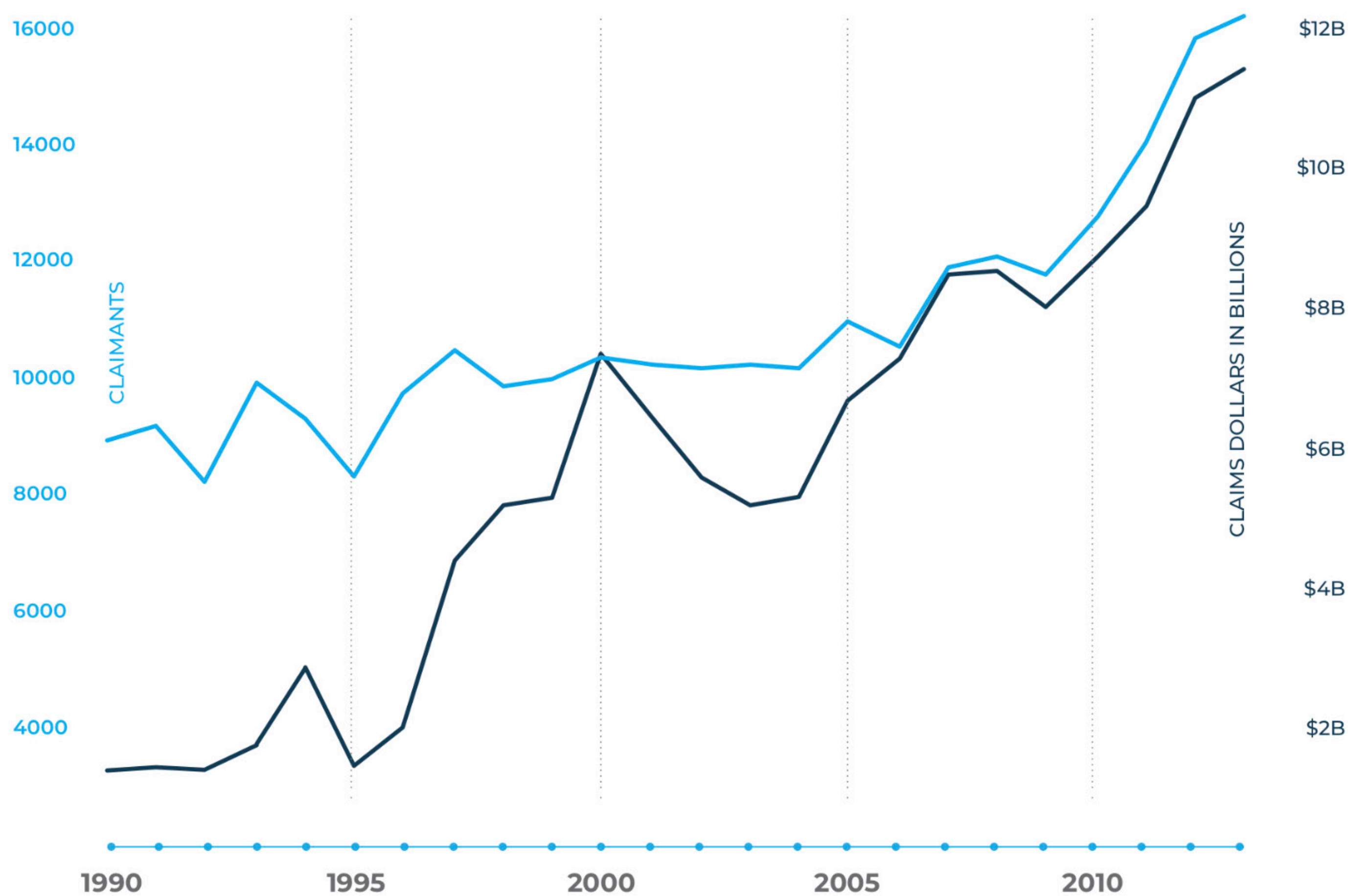
CREDITS CLAIMED

Number of Claimants and Total Dollars Claimed

Considering the potential untapped value across a wide array of industries, this data should provide much food for thought for business owners and tax advisors looking to lower their tax bill – especially when you consider that the Wall Street Journal estimated that only 5% of eligible companies claim the R&D Tax Credit in the U.S.

Figure A. Corporations Claiming a Credit for Increasing Research Activities [2] Annual Percentage Change for Tax Years 1990 - 2013

[all figures are estimates based on samples]



Source: Statistics of Income Division: 1990-2013 Corporation Returns Data

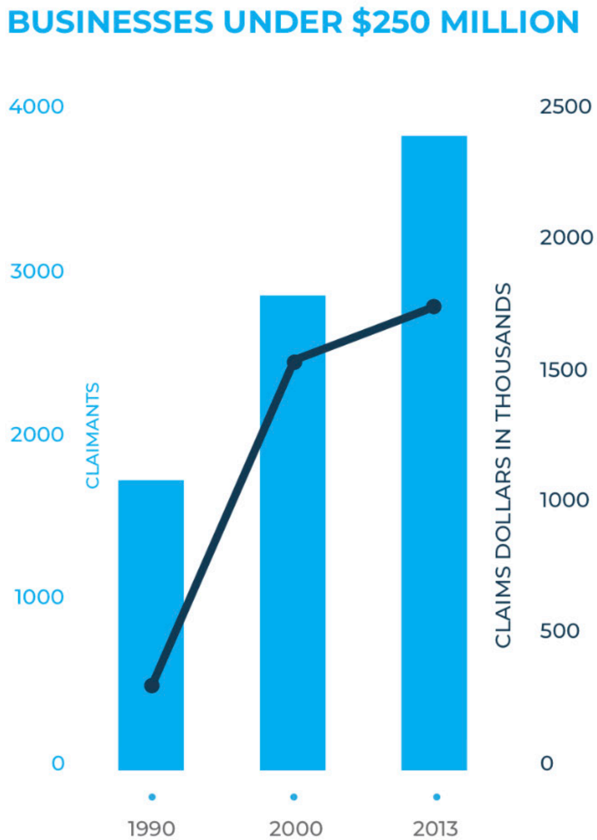
Note [1] http://www.wsj.com/articles/SB10000872396390444025204577543060812237798

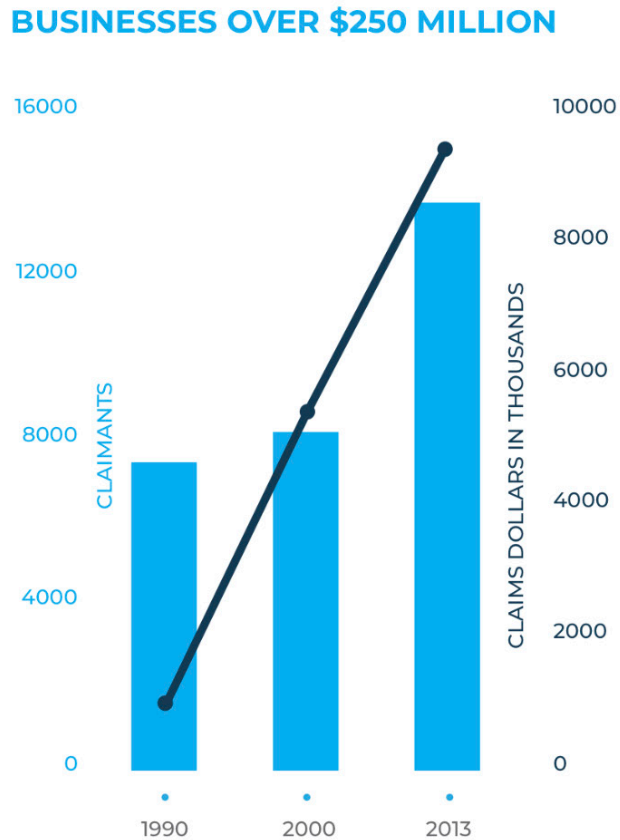
Note [2] Includes returns of active corporations, other that Forms 1120S, 1120-REIT and 1120-RIC

THE DANGERS OF SELF-CENSORSHIP

Companies with more than $250 million in gross receipts receive an average credit of $4.8 million, while companies below the $250 million mark too often either fail to claim the credit or don't maximize the amount they can take. While there has been a growing awareness of the credit, executives should take care not to self-censor when it comes to deciding whether their business qualifies for the R&D Tax Credit.

Figures B & C. Corporations Claiming a Credit for Increasing Research Activities [1]
Number of Credit Claimants by Size of Business Receipts [2]
[all figures are estimates based on samples]





Sources: Statistics of Income Division: 1990, 2000 and 2013 Corporate Returns Data
Note: [1] Includes returns of active corporations, other than Forms 1120S, 1120-REIT and 1120-RIC
*[2] *Business Receipts* is defined as the gross operating receipts of the corporation reduced by the cost of returned goods and allowances.*

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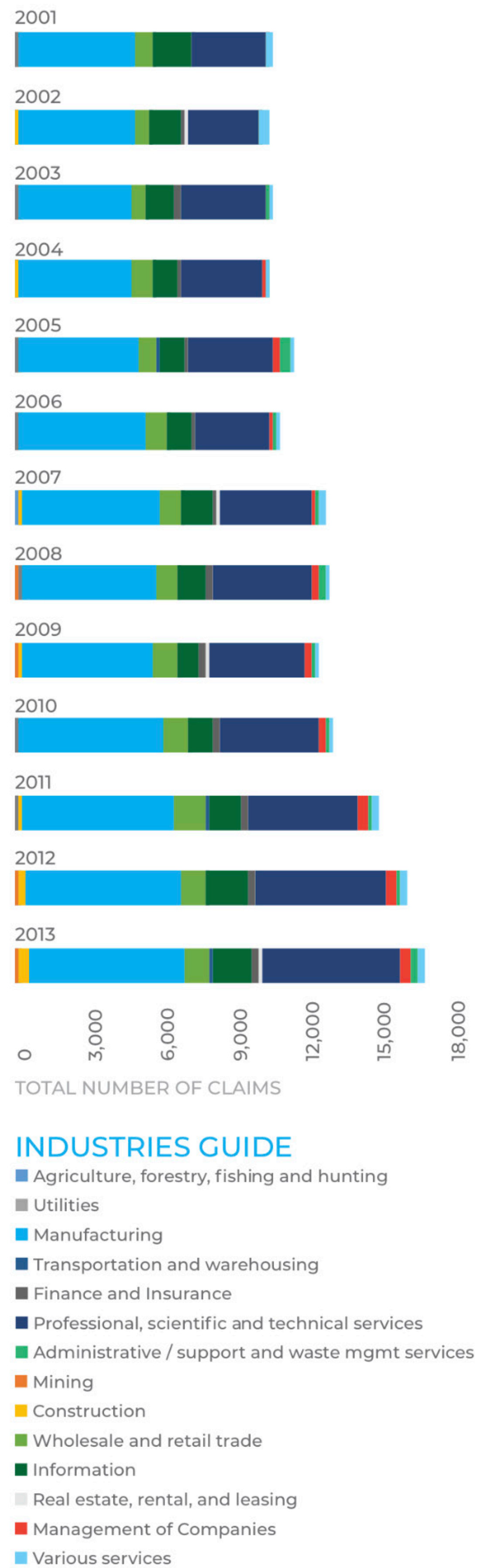
THE INCREASING NUMBER OF R&D CLAIMS

The most important takeaway from the IRS data is the expansive range of industries that can take advantage of the R&D Tax Credit. Too often executives and managers simply don't realize their work may qualify.

Manufacturing remains at the top of the list with 37.5% of the R&D Tax Credit claims. Executives should pay particular attention to the variety of businesses within manufacturing that have benefitted from the R&D Tax Credit – including paper, petroleum, plastics, electronics, furniture, food manufacturing and processing.

Additionally, one third of the claims come from professional, scientific and technical service industries (think architects, engineering, etc.), while others include software, construction, finance and transportation. However, some sectors of the economy are likely underrepresented as many of these businesses are formed as pass-through entities. For instance, the IRS places the number of agriculture companies claiming the credit at less than a hundred, when alliantgroup alone works with well over a hundred agriculture businesses a year to claim the credit.



Source: Statistics of Income Division: 1990-2013 Corporation Returns Data
Note: [1] Includes returns of active corporations, other than Forms 1120S, 1120-REIT and 1120-RIC

EVOLUTION OF INDUSTRIES

The thing to remember is that the R&D Tax Credit isn't just for rockets and curing cancer (although they do qualify). It isn't just basic science but also applied science, making that new or existing product better, quicker, cheaper, faster or improving a manufacturing process to make it cleaner or greener. With the increased focus on technology and automation across all industries, the R&D Tax Credit is becoming even more relevant for companies who in the past may not have qualified. Businesses are doing more activities in-line with qualifying for R&D than they think, thanks to new technology and the evolution of industries:

- Agriculture operations using GPS-enabled vehicles and improving fertilizer or feed mixtures
- IT services companies writing their own code and implementing custom systems
- Food processors utilizing robotics to increase production rates
- Manufacturers creating custom equipment and new products
- Computer engineers developing algorithms specific to proprietary projects

These are just examples of how companies within specific industries have evolved to meet customer demand while simultaneously are conducting activities that would qualify them for the government incentive.

So unless your company has been making the exact same product the exact same way, it might be time to take a long, hard look at the R&D Tax Credit.

DID YOU KNOW?

Agriculture companies care excellent candidates for the R&D credit due to activities like the constant reformulation of fertilizer, improvements in task automation and implementing new equipment for better yield.

EXPANDING THE TAX BENEFIT

State credits, AMT, ASC, and how they can all help small to mid-sized businesses

Currently, nearly 40 states also have a state-level R&D credit – so qualifying for the federal credit will often translate into big savings on state taxes as well.

With the passing of the 2015 PATH Act, the credit not only became a permanent part of the U.S. tax code, but more companies than ever are able to take advantage of the credit thanks to AMT (Alternative Minimum Tax) turn off, that would allow for companies who previously did not qualify now have the ability to claim the credit.

Also good news, the IRS and the U.S. Department of Treasury have put out guidance and regulations that make it easier for businesses to take the Alternative Simplified Credit (ASC) on amended returns. This means that if you haven't taken the R&D Tax Credit, you can go back three years and amend your return to claim those benefits. This is a big plus, especially for small and medium-sized companies.

In addition, new regulations have also made it simpler for computer software to qualify for the R&D Tax Credit, so any interactive website you develop can qualify. Finally, the courts have outlined the circumstances when government contractors can qualify for the R&D Tax Credit, clarifying one of the big misunderstandings for business owners thinking they can't qualify if they are paid for the work.

The IRS data serves as a useful reminder to business owners, managers and tax advisors that the R&D Tax Credit can provide a significant benefit to businesses across a wide range of industries – and coupled with positive changes in the regulatory landscape and at the state level – it is time to look at whether your business can qualify and enjoy the significant tax savings offered by the R&D Tax Credit.

DID YOU KNOW?

Engineering firms are the most likely among all industries to be performing activities on a daily basis that qualify for R&D credits.

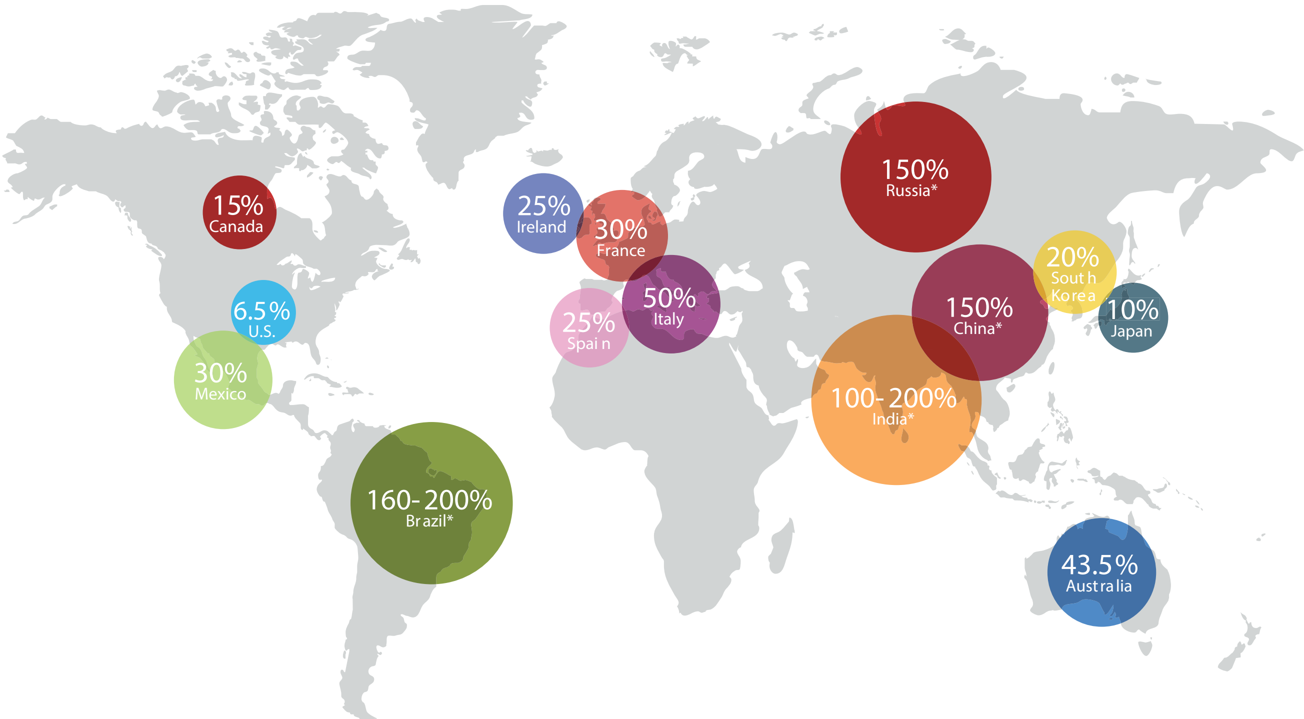


Figure E. Research & Development Incentive Deduction and/or Credit Activity Value Percentages by Country
[claim restrictions vary by country]

STAYING COMPETITIVE

Incentives for innovating is not limited to just the U.S., as many other first world countries offer extremely generous incentives for research & development. The intention of the credit in other countries is the same as it is for the United States: to encourage businesses to retain technical talent within the country. In many cases however, it would appear that other first world countries are doing a better job by offering more robust incentives. Remaining competitive from an incentive perspective on a global scale will be important for the health of the American economy, as more companies continue to make their home in the U.S.

DID YOU KNOW?

The R&D Tax Credit was initially implemented to incentivize American businesses to keep technical labor in the country and deter outsourcing.

FAQ

Q: I don't think my company invents anything, can I still qualify?

With the changes throughout the years to the qualification rules, more companies than ever before can now take advantage of the credit. Essentially, the credit is designed to be a driver of innovation and improvement of processes – so if the projects that your company are performing aren't all exactly the same, then it's extremely likely that that company would qualify for the credit.

Q: Why does the government offer the R&D Tax Credit?

The intent of the credit is to encourage companies within the U.S. to keep technical talent within the country while simultaneously continuing to drive innovation. This keeps not only your company, but the country, competitive both domestically and internationally.

Q: I have a CPA, why haven't I heard of this?

Even though the credit has been around since 1981, the credit has gradually evolved over the years, with many companies not even able to take advantage of the incentive until the changes that were made in 2015. Due to its gradual evolution over the years, many CPAs may not be up-to-date on the most recent laws and regulations regarding the credit. We proudly partner with more than 4,000 CPA rms across the country to assist them in providing this service for their clients.

Q: Does my company need to be in a specific industry?

Nope! There are hundreds of industries that qualify for the credit as it is fact specic to your everyday activities and work projects.

Q: Does the credit apply just once or every year?

The credit itself is an annual credit, and has an up to 3 year look back. This is one of the most complex areas of the tax code – that's why we exist.

DID YOU KNOW?

Manufacturing companies have the highest amount of overall claims for the credit thanks to continual improvements in processes and procedures.

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FAQ

Q: This sounds too good to be true. Is it?

Not at all! Fortune 500 companies have been taking advantage of the credit for decades, and now with the recent changes, more small to medium-sized businesses than ever before are claiming the credit. But even with the increase in claims, only 5% of companies that qualify for the R&D Tax Credit are taking the time to do so.

Q: Why should I partner with alliantgroup for this? Can't I do this myself?

While the credit is available to businesses to take advantage of, the IRS isn't simply handing out credits. alliantgroup has industry focused professionals, who understand and identify the key activities of your business that qualify. More often than not, companies who have claimed the credit on their own are not claiming the full value they are entitled under the tax code. It's hard to stay abreast on all the changes within the credit, as it has changed more times in the last 5 years than in the previous 30.

Q: I already claim this credit, why should we revisit this credit with alliantgroup?

After claiming the credit, do you still have tax liability? If so, then it's worth having our industry experts take a second look as it is commonplace for us to nd 3-4 times as much as previously claimed.

Q: Is this worth my time?

Absolutely. Since the changes in legislation and tax reform, the R&D Tax Credit remains one of the most valuable incentives oered by the U.S. government for businesses to remain competitive.

Q: How does this all work?

alliantgroup oers a turnkey solution for businesses across all industries and CPA rms that are interested in pursuing the R&D Tax Credit. To learn more about the process, contact us at education@alliantgroup.com.

DID YOU KNOW?

Architecture firms, even though they typically produce work for third parties, are able to qualify for the R&D Tax Credit.

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CONTRIBUTORS

Dhaval Jadav

alliantgroup Chief Executive Officer

Dhaval Jadav is the Chief Executive Officer at alliantgroup, America's leading provider of tax credits and incentives to U.S. businesses. Jadav co-founded alliantgroup in 2002, and since its inception, his passion to serve businesses and the CPA firms that advise them has resulted in alliantgroup helping U.S. businesses claim more than $6 billion in tax credits and incentives.

Prior to founding alliantgroup, Jadav worked at Deloitte & Touche and was a member of a mergers & acquisitions/private equity group in San Francisco, California where he advised numerous high-tech companies. He is a licensed attorney and received his LL.M. in taxation from Georgetown University Law Center.

Dean Zerbe

alliantgroup National Managing Director Washington, D.C. Office

Dean Zerbe is National Managing Director for alliantgroup and is based out of alliantgroup's Washington, D.C. office. In this role, Dean is responsible for, among other things, monitoring tax-related legislative activity in Washington to help keep our clients and staff informed and help direct alliantgroup's service offerings to ensure we are meeting client needs. Prior to joining alliantgroup in February, 2008, Dean was Senior Counsel and Tax Counsel to the U.S. Senate Committee on Finance, where he worked closely with then Chairman of the Finance Committee, Senator Charles Grassley (R-IA) on tax legislation.

During his time on the Finance Committee, Dean was intimately involved with almost every major piece of tax legislation that was signed into law – including the 2001 and 2003 tax reconciliation bills (representing two of the largest tax cuts in the nation's history); the JOBS bill in 2004 (corporate tax reform); and the Pension Protection Act.

Steven Miller

Former IRS Acting Commissioner; alliantgroup National Director of Tax

In a career devoted to government service, Steven T. Miller has spent the last 25 years with the IRS, serving the agency in a number of diverse and increasingly important roles. He served as former IRS Acting Commissioner in 2012, but prior to that Steven served for several years as the Deputy Commissioner for Services and Enforcement, leading all IRS enforcement and service activity. Steven also served as the Commissioner of the Large and Mid-Size Business Division, overseeing IRS audits of large taxpayers and the IRS programs relating to offshore tax compliance and international tax law enforcement. As the Commissioner of the Tax Exempt and Government Entities Division, he supervised the IRS oversight of governments, tax exempt entities and retirement programs.

CONTRIBUTORS

Rick Lazio

Senior Vice President; Former Congressman

Rick Lazio is a former U.S. Representative from New York, who served four terms in Congress from 1993-2001. During his time in office, Rick was known as a strong advocate for small businesses, sponsoring impactful legislation such as the successful Small Business Tax Fairness Act. Upon completion of his public service, Rick moved to the private sector to work for JP Morgan Chase as a Managing Director and then Executive Vice President.

As an alliantgroup Senior Director, Rick has continued his support of small to mid-sized businesses, brokering his insight and experience in both the public and private sectors to provide strong incentives for job growth. This interest has extended into his civic and philanthropic work in New York with the Committee for Economic Development and the Association for a Better New York.

Kathy Petronchak

Former IRS Commissioner of Small Business/Self-Employed Division; alliantgroup Director of IRS Practices and Procedure

Kathy Petronchak is the Director of IRS Practices and Procedure at alliantgroup and is part of the alliantnational group in Washington, DC. In this role, she provides assistance on a wide range of procedural issues related to IRS procedures, such as pre-filing agreements; alternative dispute resolution; statute of limitations; account problems, and penalty issues. She also assists in representing clients before the IRS with an examination or appeal issue.

Prior to joining alliantgroup in December 2013, Kathy had 34 years experience in directing IRS compliance activities and providing tax controversy services. Her experience at IRS included positions as the Commissioner of the Small Business/Self–Employed Division (SB/SE); where she worked directly with small and mid-sized businesses and practitioners on compliance with IRS standards. She also served as Chief of Staff to the IRS Commissioner and help several executive positions in the Large and Mid-Size Business Division.

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India - *Section 35(1) of the Income-Tax Act, 1961 (the Act)*

Ireland - *Year of statutory regime for R&D tax credit: 1 January 2004*

Italy - *Law Decree (Decreto Legge) No. 145/2013, art. 3 and subsequent changes and integrations.*

Japan - *Article 42-4 of the Special Taxation Measures Law*

Mexico - *Income Tax Law (Year 2017)*

Russia - *Tax Code of the Russian Federation Part One and Part Two*

South Korea - *Tax credit for R&D expenditures — Article 10 of the TILL*

Spain - *Articles 35 and 39.2 of CIT Law 27/2014, Article 38 of CIT Regulation approved by Royal Decree*

United States - *Federal research credit: Section 41 of the Internal Revenue Code*