Stu's View

By Stuart W. Margolis, CPA MT

Are You Taking Advantage of the Research & Development Tax Credit?

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The printing industry traditionally has not benefitted from tax incentives and credits that apply to other industries. There is one often overlooked opportunity, however, that printers can use to their advantage. Known as the "Research and Development Tax Credit," this is a real reduction of tax available with a reasonable amount of effort, just by documenting your normal research and development efforts.

The R&D credit has been available for many years, but due to its significant complexity and high threshold to qualify for the credit, it has only been utilized by large companies or companies with internal tax staff. In the past, products had to be almost patent-ready in order to qualify. More recently, though, the IRS has relaxed the reporting requirements and has simplified the computations. This credit now has general appeal to any size company that invests any amount of time in R&D activities.

Under prior laws, the benefit of R&D expenditures was only available if it exceeded an average of prior year expenditures. The new law eliminates that prior year threshold requirements for the first three years of utilizing the credit.

<u>What qualifies as R&D expenditures?</u>
The IRS has a four part test to determine eligible R&D costs:

- A level of uncertainty exists when the project begins.
- The project is technological in nature (involves use of technology or science, not a marketing study).
- The process is one of experimentation, such as trial and error.
- The process is conducted for a permitted purpose (new or improved function or performance, lowering of costs, increasing efficiency, etc.).

So how do we go from these IRS tax credit definitions to what printers actually do? Examples of qualifying activities include:

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- Efforts to engineer and manufacture new and improved products
- Efforts to make more precise, economical and versatile processes (such as developing production control software), or automating internal processes (such as scheduling), or developing inventory controls (such as bar coding)
- Development of prototypes or models
- Design and testing of tools, jigs, molds and dies
- Development or application of patents
- Performance of certification testing
- Performance of environmental testing
- Adding new equipment or upgrading systems (labor and engineering cost aspects)
- Conducting testing of new or enhanced concepts and technology, such as using new materials and compounds (inks, coatings, glues, UV, drying agents)
- Development of business process improvements (some costs of building may qualify), such as video monitoring for machine operators and stock security

Note that these activities must be true "R&D" – i.e., they cannot be directly charged to a customer.

Data Gathering Process

Once you have identified your eligible projects, what data is needed to report your R&D Tax Credit? For each project, you need to delineate the direct costs incurred in conducting the project. This includes identification of the direct materials and the cost of labor, including outside expenditures (such as for consultants, special machinery, software, etc.). And remember, the project need not be a success. Test projects -- or even failed projects -- can qualify.

Here are some common expenditures that need to be isolated by project, or allocated across various projects.

- Gross payroll (production personnel, IT staff, management)
- Outside labor costs, temporary labor, and engineers and consultants @ 65%
- Direct materials, supplies, and costs (such as increased utility expense)
- IT costs of hardware, software and other "dedicated" equipment
- Training costs (internal and external)
- Product/project assessment costs, such as travel (Drupa, Graph Expo, etc.)

The more detailed you are here, the better. The information that goes on the tax form is a simple summary of the detail, and reported in aggregate summary and not by project. However, your accountant will need this information to support preparation of the R&D tax form. This detailed information must also be available in the event of an audit.

Computing the Credit

For the first three years, the credit is simply computed as 6% of the eligible expenditures. This is advantageous because a credit is better than a deduction. A deduction reduces your taxable income, and your benefit is your tax rate times your deduction. A credit on the other hand is a direct reduction on your tax.

For all subsequent years, the prior law is in effect for the tax credit. This requires that annual expenditures must exceed the average of the prior three years expenditures.

Example:

Year	1	2	3	4
Actual Expenditures	$500,000	$300,000	$100,000	$500,000
Eligible Expenditures	$500,000	$300,000	$100,000	$200,000
Tax Credit %	6%	6%	6%	12%
Tax Savings	$30,000	$18,000	$6,000	$24,000

Remember that for Year 4 and forward, expenditures must exceed the average of three prior years:

$500,000 + $300,000 + $100,000 = $900,000 / 3 years = average of $300,000

In each subsequent year, eligible expenditures must exceed the $300,000 in this example. Even though you must now achieve a higher threshold of eligible expenditures to claim the credit, the benefit is that the credit is now 12%, not 6%.

Of course, you should consult your tax preparer for your actual tax calculations and your specific company's eligibility and tax effect. Part of consulting your tax advisor should be a discussion of whether it makes sense to go back three years to file amended tax returns or not.

As you can see, R&D tax credit eligibility is possible if we comply with the IRS definitions and use our own skills. Don't overlook this significant tax break, and the opportunity it presents to technologically advance the printing industry. Our industry has already evolved into providing customer products in shorter time frames, at lower costs and with a reduced impact on the environment. Only by developing core processes and keeping up with the latest technologies can we continue to meet our customers' needs and expectations – and now the government will even give you money back in the form of this tax credit for doing it.

Stu's View is contributed by Stuart Margolis, CPA and Partner of MargolisBecker LLC to provide information that helps firms operate profitably. More information can be found at www.margolisbecker.com.

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