Specialty Tax Incentives
For 2020 Tax Filings
About Dave Mitchell

- Director of Business Development
- Responsible for Illinois, Wisconsin, Indiana
- Over 20 years experience helping Manufacturing and Engineering companies
- Proud affiliate member of TMA
About Kim Lochridge

- Executive Vice President
- Partner
- Multiple Board Positions – 1031 Exchange, ETS
- Over 20 years in public accounting
- Multi-national speaker – Israel, Australia, UK
- Tax Committee for the Real Estate Round Table D.C.
About ETS

NATIONAL LEADER OF SPECIALTY TAX

• Established in 2000
• 100+ employees
• Tax Attorneys, Engineers, CPAs on staff

How We Help: Reduce Tax Liability and Increase Cash Flow

• R&D Tax Credit Studies
• Cost Segregation – Accelerate Depreciation
• Partial Asset Distributions Studies
• DEIRA Reports – Insurance Coverage
• Energy Tax Credits
Research & Development
Research Tax Incentives are available for qualified research activities conducted at the:

- Federal
- Multi-State Levels

Substantiation of the U.S. Federal-Level Research Tax Credit requires both credible testimony and contemporaneous documentation.
Although passed into law in 1981 as a temporary provision within the Code, the RTC has been extended every year with only one exception. From July 1, 1995 through June 30, 1996

- R&D is now permanent with no AMT limitations for 2016 and forward.

- Startups, AMT, and ASC also have been enhanced
Research Tax Incentives

ETS Educational Website Videos
It should be noted that as of April 2007 the RTC was an IRS Tier 1 Directive. In 2013 the Tier Directives were abolished.

That meant that taxpayers who:

- failed to claim a RTC on a timely filed tax return
- were taxable (i.e., not in an NOL situation)
- amended their tax returns during open statutory years

They were reviewed by the IRS before claim was processed.

This is no longer the case.
AMT TURNOFF FOR “ELIGIBLE SMALL BUSINESSES”: Qualifying companies can offset against AMT

- Needs to:
  - Have under $50M in gross receipts (prior 3-yr average)
  - Be privately held
- The “AMT turnoff” rule was also in place for 2010

PAYROLL TAX REDUCTION FOR START-UP COMPANIES

- Needs to have:
  - Under $5M in gross receipts
  - No gross receipts more than 5 years ago
- Payroll tax reduction capped at $250,000
- Election allowed for up to 5 years
- Applies to the employer’s (6.2%) portion of FICA tax.
Identifying Qualified Research Activities (QRAs)

To identify and qualify research and experimentation activities, the subsequent four criteria must be satisfied and documented on a contemporaneous basis as set forth pursuant to I.R.C. § 41(d) and Treas. Reg. § 1.41-4.
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Applies to both **New Product Development Efforts** & **Manufacturing Process Improvements**

1. **Permitted Purpose (§41)**
   The activity must relate to new or improved business components:
   - Function
   - Performance
   - Reliability
   - Quality

2. **Technological in Nature (§41)**
   The activity performed must fundamentally rely on principles of:
   - Physical or Biological Science
   - Engineering
   - Computer Science

3. **Process of Experimentation (§41)**
   The taxpayer must engage in an evaluative process that is capable of identifying and evaluating more than one alternative to achieve a result.
   
   This may include modeling, simulation or a systematic trial and error methodology

4. **Elimination of Uncertainty (§174)**
   The activity must be intended to discover information to eliminate uncertainty concerning the capability, method or design for developing or improving a product or process.
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Excluded Activities

• Research after commercial production
• Adaptation to a particular customer without completing the aforementioned 4 Part Test
• Duplication (i.e. reverse engineering)
• Funded research
• Management activities, efficiency surveys, and market research
• Routine data collection & quality control
• Research conducted outside of the United States and its territories
Determine Qualifying Wages

• **Form W-2, Box 1 Wages (80% rule)**

• **Conducting qualified research**
  – Meet IRS requirements

• **Direct supervision of qualified research**
  – First-line managers supervising experimentation
  – Executives conducting or supervising research

• **Direct support of those engaged in qualified research**
  – A secretary who types research results
  – A maintenance worker who cleans equipment used in research
  – *Support does not include indirect activities such as an employee who prepares paychecks for an engineer*

Must be allocated to the appropriate project via time-tracking system or other method of documentation (lab reports, meeting minutes, emails, etc.)
Identifying, Gathering and Documenting Qualified Research Expenditures (QREs)

QRE Supplies

In general, QRE Supply costs can be claimed if the supplies are consumed or destroyed in the research process.

Expenditure Supplies Excluding:

- Land or land improvements
- Depreciable property
- Indirect research expenditures
- General and administrative expenses

For example, amounts paid for electricity used for general laboratory lighting are treated as general and administrative expenses, unless that electricity is used in operating high energy equipment necessary for qualifying research.
Identifying, Gathering and Documenting Qualified Research Expenditures (QREs)

QRE Contract Research:
- Third party contractor is 65% (up to 75% in cases for payments)

Qualifying Contract Research:
- Prior agreement
- Taxpayer must bear the expenses

Contract Research that does NOT qualify:
- Payment contingent upon Research Success
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Supporting RTC Documentation

Retain records and details to substantiate claimed QREs and QRAs.

- Wages
- Supplies
- Contract Research

Proper documentation is important in avoiding and dismissing an audit.
Research Tax Incentives

From a Best Practice Tax Controversy Perspective, the subsequent list of forms of contemporaneous documentation provides several examples of key documents that the Service typically requests to review during the course of an examination including:

- Complete Project Lists identifying the Full Scope of Research Based Projects vs. the Actual Claimed Research Projects after Conducting Systematic Project Based Interviews;
- Patents or Patent Applications;
- Annual R&D or Technology Plans;
- Research Project Authorization Requests;
- Internal and External Correspondence on R&D;
- Design Requirements or Functional Specifications;
- Testing Scripts or Testing Logs;
- Modifications Reports or Error Logs;
- Technical Reports or Plans;
- Laboratory Notebooks;
- Ingredient Consumption Worksheets; and / or
- Raw Material Usage Records.
Internal Use Software

• Must satisfy a “high threshold of innovation” test to be credit eligible.

• In October 2016, changes in the regs clarify that software is primarily developed for “internal use” if it is developed for use in **general and administrative functions** that facilitate or support the conduct of the trade or business. – Treas. Reg. § 1.41-4(c)(6)(iii)

• Limited to financial management functions, HR management functions and support services functions.
Internal Software

Internal Use Software

Software will not be deemed “internal use” if it is developed to:

- Be leased, licensed or sold
- Facilitate the viability of business interactions with third parties, such as executing banking transactions, tracking deliveries, etc.
- Function as a software portal that enables third parties to execute actions on the taxpayer’s software system.
# Food Science/Bio-Flavoring/Manufacturing

## $65,000.00 Total Tax Incentive

![Building Image](image)

## Study Highlights

<table>
<thead>
<tr>
<th>Category</th>
<th>Details</th>
</tr>
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<tbody>
<tr>
<td>Industry</td>
<td>Food Science/Bio-Flavoring/Manufacturing</td>
</tr>
<tr>
<td>Size of Client:</td>
<td>Multi-National Privately Held Food Science Company</td>
</tr>
<tr>
<td>Total Company Revenue:</td>
<td>$80 Million</td>
</tr>
<tr>
<td>QREs Identified, Gathered, &amp; Documented:</td>
<td>Both New Product Development &amp; Manufacturing Process Improvements</td>
</tr>
<tr>
<td>Size of Credit:</td>
<td>$65,000</td>
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### 2013 Federal Alternative Simplified Credit Calculation

<table>
<thead>
<tr>
<th>Qualified Research Expenses</th>
<th></th>
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<tbody>
<tr>
<td>Wages</td>
<td>$1,000,000</td>
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<tr>
<td>Supplies</td>
<td>$150,000</td>
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<tr>
<td>Contract Research at 65%</td>
<td>$100,000</td>
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<tr>
<td><strong>Total QREs:</strong></td>
<td><strong>$1,250,000</strong></td>
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<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$875,000</td>
</tr>
<tr>
<td>2011</td>
<td>$750,000</td>
</tr>
<tr>
<td>2012</td>
<td>$600,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$2,225,000</strong></td>
</tr>
<tr>
<td><strong>Base Amount (3 Year Average QREs @ 50%)</strong></td>
<td><strong>$370,833</strong></td>
</tr>
<tr>
<td><strong>Total Benefit</strong></td>
<td><strong>$879,167</strong></td>
</tr>
</tbody>
</table>

- **Statutory Percentage**: 14.00%
- **2013 Current Year Alternative Simplified Credit**: $123,083
- **2013 Current Year Alternative Simplified Credit (Sec. 280 c)**: $80,004
Conclusion

When identifying, gathering, and documenting a RTC claim, both from a qualitative and quantitative perspective, be sure to adhere to all applicable statutory, administrative and judicial interpretations and consult a true subject matter expert in this area to ensure a strong tax return filing position and a sustainable result upon IRS examination.
Q&A

For Additional Information Contact:

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