MEMORANDUM

TO: Intellectual Property Lawyers

FROM: Stephanie L. Chandler

DATE: March 20, 2003

RE: Research & Development Tax Credit

RESEARCH AND DEVELOPMENT CREDIT

The Internal Revenue Code, Section 41, includes an important incentive, referred to as the research and development credit or R&D credit, to companies engaging in substantial research and development activities. The credit is also sometimes referred to as the research and experimentation (R&E) credit, the incremental research credit or Scientific Research & Experimental Development (SR&ED) tax credit. It is likely that many of our clients may qualify for the R&D credit in relation to qualifying expenditures that may have been previously overlooked.

How the R&D Credit Works:

The credit is a dollar-for-dollar reduction in income tax liability.[1] The credit generally equals 20% of the amount by which qualified research expenditures (QRE) for the current tax year exceed the base amount. The base amount depends on research activity in prior tax years. However, the base amount cannot be less than 50% of the current-year QRE amount. In other words, at most 50% of current-year QRE will qualify for the credit.[2]

The following expenses are examples of the types of expenses that can be included in when calculating QRE:

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[1] Though a company's deductions must be reduced by the amount of the credit taken, unless an election is made to accept only a 13% credit, in which case deductions do not have to be reduced.

[2] A company normally must reduce the company's deduction for research and development expenses by the amount of the credit. In addition, the credit may be limited depending on the amount of the company's tax liability (before the credit) and the passive activity rules, if applicable. Any unused credit can be carried back one year or forward 20 years. Even with these limitations, the amount of the credit can still be very substantial.

1. Wages paid to employees engaged in qualified research or direct supervision or support of such research.

2. Amounts paid for supplies used to conduct qualified research.

3. Amounts paid for leasing computers for use in qualified research.

4. 65% of amounts paid to others for performing research (contract research).[3]

What Qualifies as Research?

To qualify for the credit, expenditures must relate to research undertaken for the purpose of discovering information that is (1) technological in nature and (2) expected to be useful in developing new or unproved products for the taxpayer. The research need not be successful for the credit to be available. However, rules require that the research be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of technology or science. The research would also need to fundamentally rely on principles of the physical or biological sciences, engineering, or computer science.[4] In addition, qualifying research activities must constitute a process of experimentation intended to lead to new or improved functions, performance, reliability, or quality for the taxpayer's products.

Large manufacturing firms claim approximately 70% of the credits, highlighting that the types of companies that qualify for this credit are not your typical pharmaceutical research and development companies or new technology companies. If a company is (a) improving or creating a new product; (b) developing custom equipment or machinery; (c) creating or improving a new manufacturing process, (d) developing prototype equipment, or (e) developing software, they may qualify for R&D tax credits resulting in additional dollars added to the bottom line.

Steps in Calculating the R&D Credit

1. Determine the company's history of qualified research by analyzing the following:

a) Determine if the taxpayer had qualifying gross receipts and qualifying research expenditures in the current year.

b) Identify the first year the taxpayer had gross receipts and qualifying research expenditures in the same year.

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[3] Depending on the type of work performed, some of the legal expenses associated with the process of protecting inventions through patents could also be considered in calculating the credit.

[4] Expenses related to efficiency surveys, management studies, market research, routine data collection, and quality control do not qualify as R&D expenditures.

c) Determine the relevant years for calculation of the fixed-base percentage.

2. Determine the fixed-base percentage by dividing total qualifying research expenditures for the relevant years by total gross receipts for the same years. Multiply the fixed-base percentage by the taxpayer's average annual gross receipts for the prior four years to obtain the base period amount for the current year. (This amount can never be less than 50% of the current year's qualified research expenditures.)

3. Subtract the base period amount from total current year qualified research expenditures and multiply the result by 20% in order to obtain the current year research credit. Subtract the amount of the credit from the current year expenses deducted on the tax return or from the basis of capitalized research expenditures.

4. Taxpayers may annually elect to claim a reduced credit (13%) and not adjust the research expenditures by the amount of the credit. The election must be filed with the tax return and is irrevocable for that tax year.

Conclusion

With companies constantly scrambling to keep pace with changes in technology and markets, the odds of incurring R&D expenses are higher than ever. When such expenses occur, the potential for claiming valuable tax credits should not be overlooked. Please note, however, in some cases overlooked credits may open up opportunities to retroactively claim benefits by filing amended tax returns.

If a client may qualify, it is recommended that they speak with their attorneys and accountants to make sure they are receiving the credits they deserve.