



# Something to Mill On:

## The Research & Experimentation (R&E) Tax Credit

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*Inject cash into your bottom line!*

The Research & Experimentation (R&E) tax credit - also known as the *Research & Development (R&D) tax credit* - is now available to companies in the machine-tool industry for such activities as designing parts to meet customer specifications, improving customer designs, and refining or developing manufacturing processes.

### ABOUT R&E TAX CREDITS

The R&E tax credit has been in existence since 1981, but recent regulations have relaxed the definition of qualified research activities and the record keeping requirements. Consequently, many companies that were not eligible in the past may now take advantage of this federal tax credit. Furthermore, the changes to the governing regulations are retro-active, meaning companies may file amended tax returns to obtain refunds of previously paid income taxes. In some cases, companies may recapture taxes paid up to four years ago.

The R&E tax credit is a wage-based tax credit available for the *development or improvement* of products, processes, techniques, formulas, inventions or software. In addition to R&E wages, companies may capture supply costs for prototypes, as well as 65 percent of contracted labor used during the development process. This tax credit is available to all entities filing a federal tax return. In addition, more than 30 states offer a modified R&E tax credit.

Companies can benefit by both deducting the research expenditures and by claiming the credit. While the research expenditures are a reduction of taxable income, the R&E tax credit is a dollar-for-dollar reduction of tax. In addition, any fees paid to advisors for documenting the credit are deductible in the year paid.

The R&E credit is calculated by comparing recent years' research activities to a base amount with 20 percent of the increase in activities captured as the tax credit.

Companies must first use the credit to offset tax for the year the credit is generated. However, if additional credit remains, the company may carry the credit back one previous tax year or forward to the next 20 years.

#### Does your company...

- Manufacture products?
- Design tools, dies, fixtures or jigs?
- Develop new, improved or more reliable products or processes?
- Develop prototypes, models, or samples?
- Develop or apply for patents?
- Perform certification testing?
- Attempt to use new materials?
- Add new equipment?
- Develop new technology?
- Develop or improve production or manufacturing processes?
- Develop production control software?
- Implement quality standards?
- Adhere to regulatory bodies?
- Improve or build new manufacturing facilities?
- Expend resources on outside resources to do any of the above-stated activities?

**If you answered "yes" to any of these activities, you may qualify!**

## REQUIREMENTS

There are three basic requirements for research activities to qualify:

1. Qualified research activities are defined as the development or improvement to a business component, which is defined as a product, process, technique, formula, invention or software.

**Machinists are continually developing or designing custom parts, fixtures and tools to meet customer specifications. Most tools are unique products for the company and constitute a business component.**

2. The research must be technological in nature. That is, the process of experimentation used to discover the information fundamentally relies upon the physical or biological sciences, engineering or computer science. Furthermore, companies may use existing technologies and may rely upon existing principles to satisfy this requirement.

**Machinists rely heavily on the principles of the physical and engineering sciences to develop or improve their products or processes.**

3. The research must be intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the capability or method for developing the business component is unknown, or if the appropriate design of the business component is unknown.

**Machinists are constantly searching for more efficient and effective ways to design or build parts. There is an endless supply of specifications and alternatives to be considered in designing a part – adhering to tight tolerances, special fixturing requirements, experimenting with different types of materials, maintaining uniform radii in the lathing process, eliminating warpage in welding processes, and maintaining speed of milling process without breakage – all of which are uncertain at the outset of the part design and manufacturing process.**

## MPP&W, P.C.'s PROCESS

*MPP&W, P.C. has developed a five-phase process for documenting and substantiating the Research & Experimentation Tax Credit.*

### Phase 1: Preliminary Assessment – No charge

*At the initial meeting, MPP&W, P.C. works with management to identify important areas of opportunity as they relate to the R&E tax credit and determine if it makes sense to proceed with a calculation illustrating the benefit of the R&E credit.*

### Phase 2: Estimate of Credit – No charge

*After discussing guidelines of the credit with management, MPP&W estimates the potential qualifying research activities for each available tax period. Using this information, an estimate of potential tax savings and future benefits is determined.*

### Phase 3: Employee Interview Process

*Employee interviews focusing on the uncertainties, challenges, improvements, and developments of the eligible products and processes are conducted, while the involvement of key employees in research activities is also determined.*

### A Sample of R&E Tax Credit Group's Results:

Size and Type of Company	Achieved Results
\$25 million Machine/Tool Shop	\$230,000 in savings
\$ 8 million Machine/Tool Shop	\$ 75,000 in savings
\$20 million Plastic Injection Molder	\$382,000 in savings
\$ 4 million Tool and Die Shop	\$250,000 in savings
\$110 million Boat Manufacturer	\$650,000 in savings
\$40 million Scale Manufacturer	\$360,000 in savings
\$30 million Survey Instrument Manufacturer	\$288,000 in savings

**Phase 4: Delivery of Study**

*A detailed report containing descriptions of the new products and processes of the Company, as well as a detailed calculation of the credit for all eligible tax periods by the Study is delivered. This report serves as documentation for your tax credit.*

**Phase 5: Planning for the Future**

*MPP&W assists management in claiming future credits, discussing required documentation, capturing time applicable to qualified activities, and implementing methods of record keeping.*

## COMMON MYTHS ADDRESSED

**Myth: We are a small company. This credit is just for big business.**

*There is no size requirement for the R&E credit. Both large and small companies are potential candidates for the credit. If you have improved your products or processes, you may be eligible.*

**Myth: We'll just tell our CPA to file the right form at the end of the year to receive the credit.**

*Successfully claiming the R&E tax credit is more complicated than just filing the appropriate form. Highly specialized knowledge of current and historical requirements is necessary to substantiate and defend your claim.*

**Myth: Our CPA looked into this a few years ago. We didn't qualify.**

*Recent changes to Treasury regulations have changed the definition of qualified research, allowing many more manufacturers' activities to qualify.*

**Myth: I'm not sure the credit is worth the time and energy.**

*The credit is worth the time and energy. Due to the relaxed definition of qualified activities, credit amounts tend to be significant and the process of documentation is designed not to disrupt operations.*

The Research & Experimentation tax credit is an excellent instrument to retain cash in a company. As a company in an ever-evolving industry, the credit provides an opportunity to offset some risk assumed by the company and encourages constant innovation.

## ABOUT THE AUTHORS

*Adam Herman, CPA/ABV, CVA, ASA and Michael Devereux are members of MPP&W, P.C.'s R&E Tax Credit Group, a division of a regional, St. Louis-based CPA and business advisory firm. The R&E Tax Credit Group specializes in assisting manufacturers and their advisors in maximizing the R&E tax credit. For more details, visit [www.mppw.com/RE](http://www.mppw.com/RE).*

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