R & D Tax Credit Fundamentals

By Charles R. Goulding and Charles G. Goulding

Charles R. Goulding and Charles G. Goulding explain the basic principles of the R & D tax credit and discourage company executives from assuming that their company does not qualify for the credit.

For over 30 years, the Federal Research and Development (R & D) tax credit has helped American firms recoup the costs of their innovation. The vast majority of these firms are not engaged in white lab-coat activity, as one might associate with the term "R & D." By contrast, the credit is available to any company that meets the criteria described herein. Since 1981, the credit has existed in all but two years; in the likely event it is again extended, firms seeking growth through innovation should familiarize themselves with the basic principles of R & D tax law.

Qualifying for the Credit

Employee wages drive the credit. Eligible employees must work within the hard sciences, engineering or software development. Ideally, those employees either have formal training in a relevant technical discipline and/or a lengthy professional background in their trade.

Eligible wages must then be allocated to particular projects, termed "business components" in the law. The most common business components are specific products and processes. In addition, business components can include techniques, formulas, inventions and software. It is not enough to report qualified wages on a general level, without segregating them into components. Bayer, the leading pharmaceutical, remains in ongoing litigation centered on this very issue.[1]

Further, it is not enough to show that a technical employee has contributed on a general level to a given project or business component. Eligible activity must relate to specific "permitted purposes" that the law regards as especially contributory toward innovation. These include making a given business component more reliable, functional, higher quality, better performing or more cost effective.

The kinds of activities that frequently achieve these ends include prototype development and testing, product design and redesign, process development (pre-production), technical feasibility analysis and patent application work. Frequently, these activities help resolve instances of technical uncertainty and involve the examination of alternatives. Both technical uncertainty and the examination of alternatives are specifically cited in the law as key determinants of eligible activity. The challenge for a taxpayer is to uncover and demonstrate the extent to which these principles of scientific discovery underlie their own firm activity.

Documenting the Credit from the Bottom Up

Ultimately, each employee has a percentage applied to his wage reflecting the portion of his time spent

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on R & D. Substantiating this percentage is a list of eligible business components showing which employees contributed R & D to which component.

Firms using project-based accounting are in a better position to tie their employees' R & D activities to specific business components. By contrast, firms using cost-based must supplement their documentation more thoroughly to arrive at appropriate estimates. Supplementary items include contemporaneous documentation—meaning documents generated at the time of R & D which corroborate the credit claim—and oral testimony from employees. The most relevant examples of contemporaneous documentation should be procured into a binder, and a list of other potential resources, such as emails, logs, notes, travelers, models, outside contractor reports, *etc.,* should be developed.

Firms are not disqualified simply because they may be required to estimate certain figures due to their accounting methodology. In *G.M. Cohan*, a taxpayer without exact records of past business expenses was allowed to estimate them.[2] The same principal was later applied specifically to R & D documentation in *E.V. Fudim*.[3] The key issue today is not whether estimation has occurred, but how thoroughly those estimates are substantiated.

Regardless of the taxpayer's accounting approach, every R & D study should also be supported by interviews with relevant personnel. These interviews provide insight into the appropriate division of each employee's time as well as to the challenges faced on each project. The validity of oral testimony in particular as an element of estimation was affirmed in *A.R. McFerrin*.[4]

Documenting the Credit from the Top Down

The credit is, ultimately, a tool for national growth and job creation. As such, good documentation will also make a compelling case along these broader lines. Manufacturing firms, for example, should detail the exceptional competitiveness of the industry and its specific impact on their companies; any manufacturer that has survived the recent wave of off-shoring is well-positioned for R & D credits by sheer virtue of the competitive pressures endured. Likewise, tech startups should emphasize the shift to an incubation model on behalf of U.S. universities and the role this framework has played in job creation for the new economy.

Research has shown that for each dollar of foregone tax revenue, GDP has increased by at least an additional $1.[5] High-level connections to growth and job creation therefore tie in to the bottom line of the legislation itself. Likewise, if a firm's activities substantially connect with any governmental initiative aimed at economic development, those connections should also be highlighted. For example, firms engaged in health care innovation, particularly those products that reduce costs and streamline efficiency, relate directly to national efforts at fighting health care inflation. Excellent documentation identifies these relationships in much the same way the R & D law explicitly creates a patent safe harbor.

Conclusion

Many firms that do not take the federal R & D tax credit do so out of a mistaken belief that they are not eligible. Any firm employing professionals who are resolving technical uncertainties, testing alternatives and contributing to their firms' own knowledge bank should take a close look at this incentive. The knowledge gleaned need not be new to the world; rather, it must be part of a firm's own intellectual progress and scientific know-how.

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Endnotes

1 *Bayer Corp.* (No. 2:09-cv-00351).
2 *G.M. Cohan,* CA-2, 2 USTC ¶489, 39 F2d 540, 543-544.
3 *E.V. Fudim,* 67 TCM 3011, CCH Dec. 49,867(M), TC Memo. 1994-235.
4 *A.R. McFerrin* –DC-TX, 2007-2 USTC ¶50,551, 492 FSupp 2d 695.
5 Available online at *www.americanprogress.org/issues/tax-reform/report/2012/01/06/10975/the-corporate-rd-tax-credit-and-u-s-innovation-and-competitiveness/.*

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