

Tax Strategies to Drive Profitability in Your Business

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R&D tax credit studies

Questions:

1. Do I have qualifying activities?
2. Are we getting all we deserve?
3. Is our documentation adequate?
4. Will the recent rule changes benefit me?

R&D history & current status

- Enacted in 1981 as a temporary credit
- Extended 14 times
- Last extended in October 2008 through December 2010
- Significant change:
 - In 2006, the Alternative Simplified Credit calculation was added for years ending after Dec. 31, 2006.

R&D credit: What is it?

- Tax provision to stimulate research and economic growth in the U.S.
- A direct reduction of an entity or shareholder's tax liability (source income, taxable income & AMT tax limitations apply)
- Federal credit is a % of the qualified research expenses (QRE) in excess of a base amount limitation
- Many states allow research credits

Top 10 Reasons Companies Aren't Maximizing Benefit From R&D Tax Credits

- 1. It's "too good to be true."**
- 2. It's some sort of "tax shelter."**
- 3. I will get audited.**
- 4. I won't qualify.**
- 5. I don't do any research activities.**
- 6. I don't understand it.**
- 7. It's too much work to be worth it.**
- 8. I'm too busy.**
- 9. I didn't know about it.**
- 10. My CPA has it handled.**

What is R&D?

- Experimentation
- Seeks to solve a technical problem
- Eliminates uncertainty
- R & D does not have to be:
 - Top secret
 - Classified
 - “Rocket science”

What qualifies as R&D?

Qualified activities which create:

1. New product or process development
 - Tire manufacturer develops new material
 - Tire manufacturer develops new process
2. Product enhancements
 - Heating element in a toaster
 - Coffee pot that grinds the beans
3. Process enhancements
 - Integration of new production equipment into existing manufacturing process
 - Efforts to reduce production costs, such as different material, less energy or changes in automation
4. Software development

What is a qualified activity?

1. Process of experimentation +
2. Which eliminates uncertainty present at the beginning of the project +
3. Technological in nature – “hard science” (physical, biological, engineering or computer science); AND
4. Development of a new or improved business component

What is a qualified activity?

Final regulations focus more on how rather than what is developed.

Non-qualified activities under IRC §41

- Research performed outside the U.S.
- Funded research (i.e., by grant, contract or otherwise)
- Non-functional activities (expenses relating to style, taste, cosmetics, etc.)
- Reverse engineering
- Ordinary testing or inspection for quality control

Non-qualified activities under IRC §41

- Research after commercial production
- Routine data collections (i.e., consumer or efficiency surveys, management studies)
- Research in social sciences (i.e., literary, historical or economics)
- Financial profit forecasts/production feasibility projections/budget preparation

Qualified research expenses

- Outlined in IRC §41(b)(1)
 - In-house research expense
 - Wages
 - Supplies
 - Contract research expense

Qualified research expenses

- **Wages:**

- Excludes any fringe benefits

- Includes:

- employee time directly engaged in the research

OR

- providing direct supervision or direct support of qualified research activities

Box 1 on Form W-2 multiplied by applicable qualified R&D time allocation

Qualified research expenses

- **Supplies:**
 - Excluding land & depreciable property
 - Must be consumed in performance of qualified research activities
 - Certain overhead costs may be included (such as utilities and telephone expenses) *if* proven to be *directly* connected to qualified R&D activities

Qualified supplies under IRC §174 & 41

- Purchased materials consumed during qualified research activities (excluding land and improvements to land, and depreciable property)
- Scrapped parts or material produced during qualified research activities
- Jet fuel consumed during flight tests
- Gas, oil, metals, wiring and adhesives consumed during qualified research activities

Qualified supplies under IRC §174 & 41

- Office supplies consumed while producing reports or used during development
- Shop supplies or shop parts
- Hazardous waste
- Small tools and equipment
- Prototype expenses

Qualified research expenses

- **Contract research expense:**
 - Incurred during the research process
 - Only 65% of these costs eligible for the credit
 - Examples:
 - Outside consultants
 - Software programmers
 - Engineers
 - Outside tool & die makers, etc.

R&D tax credit studies

Triggers:

1. New product
2. Engineering department
3. Testing functions
4. New equipment
5. New technology or automation

Cost segregation studies (CSS)

Why cost segregation?

- Maximize tax deferrals and increase cash flow

What is it?

- Identifying and reclassifying personal property assets that often get buried or lumped together within the real property asset category

Cost segregation studies

How does it work?

- Building costs typically depreciated over a 39-year period are reclassified to permit a shorter, accelerated method of depreciation.
- Personal property assets reclassified to the shortest possible depreciable life
 - maximizes depreciation expense
 - reduces current income tax expense

Cost segregation studies

How does it work?

- Costs for non-structural elements can often be depreciated over 5, 7, or 15 years vs. 39 years
- Examples:
 - wall covering, carpet
 - accent lighting
 - exterior site improvements such as sidewalks and landscaping

Cost segregation studies

Qualifying property:

- Buildings that have been purchased, constructed, expanded or remodeled since 1987 (10-year window)
- Typically cost-effective for buildings and/or improvements costing more than \$750,000
- Can also be beneficial for leasehold improvements

Cost segregation studies: 5-year benefit

Assumptions:

Total cost of facility net of land: **\$4,000,000**

Depreciation without CSS:

Assume 39-year life using straight-line method **\$510,000**

Depreciation with CSS:

Assume 30% of cost reclassified to shorter lives
(15% to five-year property, 5% to seven-year
life and 10% to 15-year property) **\$1,300,000**

Cost segregation studies: 5-year benefit

Increase in depreciation deductions:

\$790,000

**Tax savings at 39% combined Federal and
State tax:**

\$308,000

Accounting methods – prepaid expenses

What is it?

- Adoption of **tax** accounting methods providing for accelerated deduction of prepaid expenses and/or recurring items
- Many prepaid expenses reported on year-end balance sheet may qualify for current deduction
- Unrecorded contractual obligation liabilities for qualifying expenses can qualify for current deduction even though not recorded for financial reporting purposes

Accounting methods – prepaid expenses

Example of potential tax benefit

Year-end prepaid expenses **\$235,000**

Consisting of

- \$150,000 ***prepaid*** property insurance
- \$ 35,000 health insurance ***for following month***
- \$ 50,000 office supplies

Accounting methods – prepaid expenses

Example of potential tax benefit

Commercial insurance payments **\$75,000**

Three installments of \$25,000 each
not recorded on the company's books
at year-end for insurance with policy
period ending 5 months after year-end

Accounting methods – prepaid expenses

Example of potential tax benefit

Adopting prepaids and recurring items methods of accounting for tax purposes allows the \$185,000 of prepaid insurance and \$75,000 of installment premiums to be deducted currently, resulting in an ***acceleration of deductions totaling \$260,000.***

Multi-state tax issues: Get the upper hand

Sales tax – to collect or not?

- Income tax – nexus planning
- Registration and franchise taxes

Kansas High Performance Incentive Program (HPIP)

Benefits:

- Up to \$50,000 training tax credit (no carryover allowed)
- Investment tax credit of up to 10% of eligible capital expenditures which exceeds \$50,000 (10-year carryover available)
- Sales tax exemption on eligible capital expenditures

High Performance Incentive Program

Who can qualify?

- Manufacturers
- Headquarters or back-office operation of national or multi-national corporation
- Non-manufacturers (within selected NAICS codes) with more than 50% of revenue from sales to Kansas manufacturers and/or out-of-state business or governmental customers

High Performance Incentive Program

Qualifying criteria

- For-profit business
- Pay above-average wages for the region vs. average for businesses with the same first 4-digit NAICS code
- Eligible employee training costs of 2% or more of total wages, or participation in KIT / KIR program
- Must file Capital Investment Project Description with Kansas Department of Commerce before committing to capital expenditures

High Performance Incentive Program

Example of benefits:

For a new facility and equipment placed in service with a total cost of \$4 million (assuming average wage and 2% training cost test met):

- ***Potential Kansas HPIP income tax credit = \$445,000***
- ***Enough credit to shelter more than \$6 million of Kansas taxable income***

Other ideas worth considering

- Selling your business? Increase value with early preparation
- Lock in key management with incentive plans
- Review retirement plan costs to uncover hidden investment expenses

Questions?

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