



Expert Discusses Generous Innovation Incentive in Tax Code

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As companies look to trim expenses during the economic downturn, some may be tempted to slash research and development (R&D) expenditures. But a little-known state and federal tax incentive, regularly used by larger corporations, can help a wide range of companies innovate while watching the bottom line.

The Research and Experimentation (R&E) tax credit in both California and federal tax codes allows companies to recover roughly 13% of their R&D expenditures, says Mike Silvio, tax director of CBIZ Accounting, Tax & Advisory in Irvine. The rule of thumb is that companies need to be uncertain about the capability, method or outcome of a project and eliminate that uncertainty through a process of trial and error.



The federal R&E credit is not yet active for the 2008 tax season, as it has expired, but is expected to eventually be renewed, Silvio says.

It's complex and often overlooked, but Silvio says companies can recover hundreds of thousands, even millions, in R&D expenditures if they qualify. Silvio spoke with California Executive about how the tax credit works and which types of businesses and activities qualify. An edited transcript of the interview follows.

California Executive: What is the R&E tax credit?

Mike Silvio: I would describe it as a reward for innovation. Anytime a company is solving a technical problem or technical uncertainty in whatever they're doing, it's a trial and error process to get through that uncertainty. That leads to innovation. Companies have to be innovative. So the government has come up with this reward mechanism in the form of a tax break to incentivize that, to keep innovation in the U.S., to be competitive in the global environment. Companies can take advantage of that to reduce their tax burden and get a little bit back for some of the R&D activities they're doing and hopefully retrench it back into the business.

That's pretty much the intent of it, and it has done pretty much what it was supposed to do. It's not as strong as it could be, when you compare it to [comparable incentives in] other countries, but it is at least something our manufacturing base can look forward to.

CE: What kinds of businesses are eligible for this? Only manufacturers?

The number one type of business is the manufacturer, but it runs the gamut. Pretty much any manufacturer is doing some sort of R&D. I'll just list some: aerospace, biomedical, biotech, defense, energy, food processors, growers, lubricants, life sciences, medical devices. All of those have some level of R&D to them.

If you go back to the definition of who it is supposed to reward, it's the uncertainty in the technical aspect in any area of product development, product improvement or process improvement.

CE: So it's more far-reaching than it seems.

Absolutely – especially in the agriculture industry. Ag is really big; central California has a lot of agricultural businesses, and I've done a lot of work in that area. Every organization from the grower – organic is a huge thing right now – on up to harvesting equipment and seed coating technology. Again, it could be in any industry.

It's a matter of how creative you want to be in looking at your business and seeing if you meet these tests.

CE: Can you give an example of an unusual or unique application of this tax?

Most companies think of the R&E tax credit as a product improvement. They look at it and ask what product they're making and what they're doing to that product. The most unusual I've seen has been in the process improvement area – not unusual for a company, but unusual when you start thinking about it from a tax credit standpoint. It's really empowering the production folks to come up with innovative ideas in how to produce the product more efficiently.

Some companies are offering incentives, saying they will give a \$250 bonus to each production employee who comes up with a new technical idea. One that I can think of was a company that was manufacturing piping for gas lines, where it goes from your house to the meter. They had to test the pipes to determine if there were any leaks. They tried to do it by putting air in it and pressurizing it, but that didn't really work. One of the production employees came up with a system where they pressurize the pipe, then drop it into a vat of water, then look to see if any bubbles came out of it.

Those are things companies are doing every day. They do those types of things to gain efficiency. The most unique is where you have production people on the floor doing things to create these efficient processes and then qualifying for the credit.

CE: Most of our readers are business owners and high-level executives at small and midsize companies in California. Generally speaking, is this demographic savvy about the R&E tax credit?

Generally speaking, they are not. The problem has been that the tax credit, which has been around since 1981, has really been known and used by the larger companies, but hasn't trickled down to the midsize and small companies. Most of the time, they're getting good advice on taxes from their CPAs, but this is very specialized.

Back in 2001, the R&E credit laws were enhanced, and then relaxed a little bit. They were kind of expanded to include more things. One of the things that is huge, which companies could not take before, is the discovery test. The discovery test said that in order for you to take the credit, you had to be the first in your industry to discover something. Well, that relegated the tax credit to the big companies. So they threw that out. Now, it just needs to be new to the company. So if they're taking a borrowed technology from another application and trying to revamp it or apply in a different way, and their competitor down the street is also doing it, they can still get R&E credits for that because it's new to them.

Most CPAs might put it on the shelf and say that's too innovative – now it's mainstream. And now it's about getting the word out to companies. I'm meeting with between \$5 million and \$15 million revenue companies all the time and they have not heard of it.

CE: I can see where that would have chilling effect if a dozen companies were concurrently working on similar experimentation, but only the first across the finish line would receive the credit.

Absolutely. It really did do that. Now that this law has changed, there are only a few of us who really know these nuances and can really take that out to companies now. That's why it has become so specialized. We're trying to spread the word.

CE: Now that the economy has slowed to a crawl, and perhaps moving backwards, aren't businesses putting much of their R&D projects on hold?

At first blush, you would think that companies would have to reign in costs. But I've seen it both ways. With some companies, R&D is the first to go; they'll just shore up their products and get out there and sell them. But the companies that really know the credit and use the credit as a cash-flow mechanism continue to do R&D because they know that the economy is going to turn around and they want to remain on the cutting edge. So they're using it as a "financing" tool, if you will, where they know if they expend \$100,000 on R&D, they're going to get back probably \$13,000 of that. So they're continuing to use it.

I'm finding that companies today that are taking advantage of the credit today are doing so because they see the benefits of it. The one caveat is that the credit has not been renewed. So it's no longer with us for federal purposes as we sit here today. But companies that know about it continue to expend dollars in R&D; not for tax credit motivation only but I think from a competitive standpoint, they're thinking they really need to continue doing that.

CE: Can you give me an example of how much money a business can save by taking advantage of the R&E tax credit?

Let's just take a \$40 million to \$50 million manufacturing company. For the activities they're doing in both product and process, I've seen credits range from \$500,000 up to about a \$1.5 million or \$2 million. So it's significant dollars for a company. It really depends on workforce, how many workers you have on the R&D activities themselves. If you're qualifying five people or so, you'll probably get a credit of about \$150,000 or so. If you're qualifying 25 to 30 people – we just qualified a company with about 25 to 30 people in a medical device company, and they're getting about \$600,000 in credits. Another example is a company that puts together spas, the kind you put in your backyard. We qualified about 40 people in their workforce, and they got a credit of \$1.5 million.

It's pretty normal to have between \$500,000 and \$1 million in credit. This is for looking back in a four-year window of opportunity. Companies have the opportunity to go back four years for California and three years for federal to capture those R&E credits they did not capture in the past.