LEYTON

Your Innovation Incentive:

The R&D Tax Credit

Every company should explore the tax saving benefit of the R&D Tax Credit, irrespective of size or industry.

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Introduction

The research and development credit is a government-sponsored tax incentive offered to companies who create or improve a product or process in the course of their business.

The credit dates all the way back to 1981, when it first became available to taxpayers on a temporary basis. At the time, its applicability was limited and the strict qualifications of its provisions meant many small businesses and startups were ineligible to apply. In 2015, when the Protecting Americans from Tax Hikes (PATH) Act was put in place, the research and development (R&D) credit became a permanent part of the tax code and with it, revised qualifications that greatly expanded the eligibility for businesses to qualify.

Today, the issue remains that many businesses still believe they are ineligible to apply because of the old guidelines, or are otherwise unaware that this valuable tax incentive rewards processes they are already engaged in. Additionally, most states offer an R&D credit that can supplement the federal R&D credit.

Between 1990 and 2013, U.S. companies received more than $146 billion in R&D Tax Credits.

This white paper is intended to explain the federal R&D Tax Credit; its purpose, applicability, and value to your business. We will describe the ways companies can benefit from and optimize the federal credit and preview the available state R&D credits.

Our goal is to demystify the rules in a way that inspires entrepreneurs, corporate executives, and small business owners to take a second look at their own efforts and recognize that the products and processes they are already doing can qualify for the R&D Tax Credit.

We will demonstrate the applicability to a variety of industries, and detail some of the technical features of the R&D Tax Credit. Finally, we will discuss the added value Leyton brings to an engagement through our unique perspective and approach, the rigor of our processes, and the expertise of our people.

1981

Originally called the Research and Experimentation Tax Credit, the legislation was included as a temporary provision in the Economic Recovery Tax Act of 1981 (ERTA). Lawmakers originally intended it to expire in 1985, but they continued to see the value that the credit had on the American economy.

1985 to 2015

Between 1985 and 2015, the credit had expired and been reenacted eight times, extended sixteen times, and modified on several other occasions.

2015

The R&D Tax Credit finally becomes permanent with the PATH Act. Along with becoming permanent, the qualifications for the credit were greatly expanded, so that it could be an advantageous tax incentive for startups and seasoned companies alike. This is why the number of companies applying for the credit has more than doubled in the last 15 years.

The R&D Tax Credit and Industries that Benefit

The R&D Tax Credit is an income tax incentive that provides a dollar for dollar offset against the federal income tax liability of U.S. companies that increase their research and development spending above an average base. It is intended to encourage U.S businesses to create new products, improve existing products, or streamline their production processes.

Research and development activities are performed every day at many of the more than 30 million small businesses in America. Any company that develops new or improved products, processes, or internal-use software is likely to qualify. In addition, any company that works to improve its trade, industrial, or materials processes – in an effort to remain competitive in its field – is also likely to be eligible to claim the credit. Unfortunately, many entrepreneurs, corporate executives, and small business owners assume otherwise.

Industries Served

Manufacturing
Automation
Automotive
Motorsport
Packaging
Plastics
Textiles
Tools & Dies
CNC Milling & Programming
3D Printing & Programming
Fashion Development/ Production/
Plastic Injection Molding
Paper Processing & Printshop Engineering
Transportation (logistics & distribution, incl. rail and trucking)
MEMS Devices (Micro-Electro-Mechanical Systems Devices)

Software & Technology
FinTech/Banking
E-commerce
Creative Entertainment
IT
Logistics
Algorithms & Analytics,
Cyber Security
Telecom
Satellite & Military communications

Engineering
Civil Engineering
CAD
Defense
Electrical Engineering
Electronics
Sub Sea Technology
Marine Engineering
Mechanical engineering
Waste Management
Aeronautical/Aerospace
Architecture Engineering
Marine & Maritime engineering
Logistics
Biochemical Engineering
Chemical Engineering,
Robotics

Food & Beverage
Food Science
Food Production
Brewery
Winery
Distillery
Craft Beer

Agriculture
Animal Health
Arable Farming
Pastoral Farming

Sciences
Bio-Tech
Chemical
Cosmetics
Composites
Ecology
Geology/physics
Environmental Science
Healthcare
Hydrology
Material Science
Medical Devices
Metallurgy
Nanotechnology
Pharma
Clinical Research/Studies

Construction
Facilities Management
Architecture
Design
BIM/CAD
Fire Systems
Land Remediation
Naval Architecture

Energy
Bio-Fuels
Oil & Gas
Renewables

Healthcare services
Doctor's offices
Specialty Dentistry
Dental Labs

*This is not an exhaustive list. Many more industries are eligible.

A common misconception is that research and development only takes place in laboratories with scientists in lab coats, or in designated research and development departments. The result is that each year, countless organizations across a wide range of industries miss out on claiming the credit because they do not realize that their operations qualify as research and development.

In fact, there is a long list of industries that may qualify for the credit. The best way to determine which activities will qualify for R&D Tax Credits in any industry is to use the IRS' four part test, discussed in the next section.

Leyton can assist companies in underrepresented industries realize that they are conducting research and development activity and can assist in their successful claim of the R&D Tax Credit.

How the R&D Tax Credit is Calculated, and How it Applies to Your Tax Return

To make sure that companies are staying compliant, the IRS has enforced a four part test that must be met by companies aiming to claim the R&D Tax Credit.

Alternatively, companies that aren't sure if they qualify may actually find themselves innovative once they look at the four part test. An activity that meets the 4-part test is a qualifying research activity.

The four parts are:

Business Component Test

Has the company demonstrated that the information being discovered was to develop a new or improved product, process, computer software, technique, formula, or invention, which is to be held for sale, lease, license, or further used in its trade or business?

Technology Test

Can the company demonstrate that its development of a business component relied upon the principles of the physical or biological sciences, engineering, or computer science?

Uncertainty Test

Has the company demonstrated that it tried to learn something new about the product or process being changed in order to improve it and has it demonstrated that the product or process could not be improved without going through this discovery process?

Experimentation Test

Has the company demonstrated that it went through a process of elimination, trial and error, or other evaluation of alternatives in order to arrive at the new or improved product or process?

An activity must meet all four parts of the four part test to be considered a qualifying research activity. An important note to consider is that success of the R&D effort is not required; in fact, an attempt ending in failure often proves the uncertainty and experimentation tests. Additionally, the new or improved product or process does not need to be new to the industry; it just needs to be innovative to the business conducting the R&D activity.

Ultimately, the amount of eligible credit hinges on the underlying Qualified Research Expenditures (QREs) related to the qualifying research activities: what costs companies are allowed to include in their credit calculation. Qualified research expenses (QRE) include the salaries of people working on research and development projects, a portion of fees paid to outside contractors, the materials and supplies used in R&D prototyping, certain leased computer expenses, and research payments made to educational institutions or scientific research organizations.

Additionally, all QRE's must be treated as expenses (instead of capitalized assets) on the company's books under IRC Sec. 174 in order to be included in the credit calculation. The final step required to evidence the R&D tax credit is establishing nexus between the qualified research activity and the QRE. Essentially, linking the activities being performed to the costs that are being incurred. It's also important to consider that expenditures must be associated with R&D activities conducted within the United States to qualify.

Once it's deemed that the activity meets the four-part test and the QRE's are identified, the actual calculation of the credit begins. The traditional credit calculation is 20% of a company's qualified research expenditures exceeding a calculated base amount during their tax year. The "Alternative Simplified Credit" calculation method is also available, which is 14% of a company's qualified research expenditures exceeding a calculated base amount.

A credit calculated for the tax year may be utilized in the current tax year as a dollar for dollar offset against any federal income tax liability. If the credit amount surpasses the amount of federal income tax liability, the unused portion of the credit may be carried forward for twenty tax years, or carried back one tax year and applied against federal income tax liability.

A company is able to "look back" three tax years to retroactively apply for the credit. A retroactive credit can be used for the applicable tax year to generate a refund, or carried forward within the twenty year period.

The credit may be applied for every year that the company conducts R&D activity. Eligible companies may also choose to apply the R&D credit towards their payroll taxes.

The Payroll Tax Credit

Qualified small businesses can use the R&D credit to reduce or eliminate the employer portion of a payroll tax (Social Security OASDI) liability . After identifying the R&D credit available to the company, an election can be made on an original, timely filed tax return to apply the identified R&D credit to offset the employer share of payroll taxes. The amount of credit that may be applied to payroll taxes is limited to $250,000 in each tax year. If the credit isn't entirely consumed in the current year, any excess can be carried forward indefinitely. The R&D Tax Credit can be applied to payroll taxes up to five times, so the payroll benefit over that 5-year period can be up to $1,250,000. It is a great option for small businesses looking to benefit from the credit immediately rather than wait until federal income tax is owed.

Internal-Use Software

When a company conducts research activity to develop computer software intended solely for its own internal use, there are additional hurdles that must be cleared if related expenses are to be claimed for R&D Tax Credits.

Expenses related to Internal-Use software are eligible if they meet these additional requirements:

1) The software must be highly innovative and show that it would result in economically significant cost reduction or other substantial and measurable process improvement;

2) Developing the software must involve significant economic risk without any certainty that committed resources would be recovered in a reasonable amount of time; and

3) Current, commercially available software cannot fulfil the required functionality of the internally developed software.

Pass-Through Entities

The R&D Tax Credit is calculated the same way for S corporations, LLCs and partnerships as it is for corporations. The credit is determined on the company level then allocated to shareholders, members, and partners on their Form K1, just like other credits and tax allocations. Shareholders, partners, and members may use their allocated share of the R&D tax credit to offset their income attributable to their interest in the company. The unused portion of the R&D credit carries forward for 20 years.

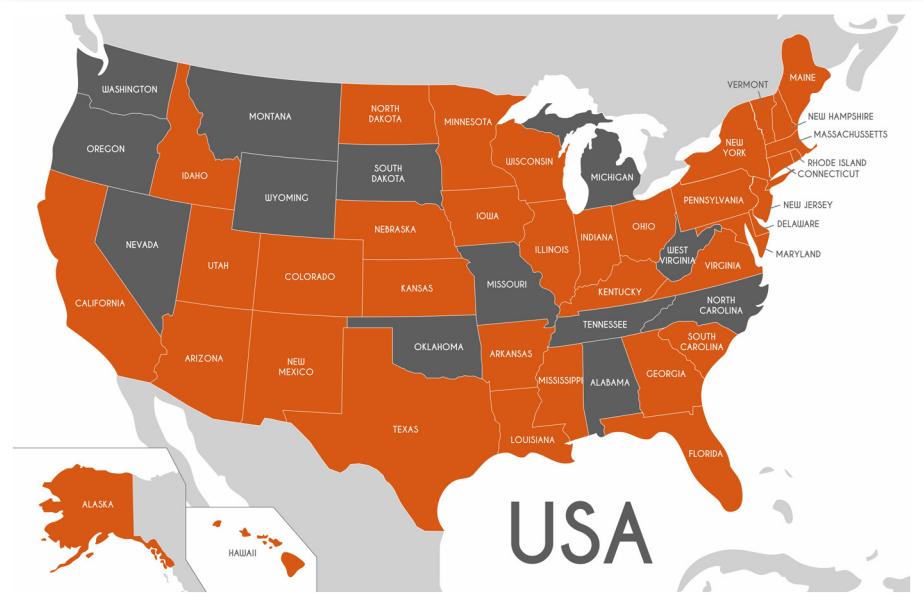
State R&D Tax Credits

The number of available state R&D Tax Credits has increased rapidly over the last 37 years and so too has "the average generosity" of those credits.

According to the Federal Reserve Bank of San Francisco, the value of a state R&D tax credit has grown four-fold since Minnesota first offered a state R&D Tax Credit back in 1982.

Like the federal R&D Tax Credit, which mandates that companies conduct research in the United States to be eligible for the credit, each state requires that research be conducted in-state for a business to qualify for the credit. So, a company that conducts research in multiple states may be able to claim credits in every one of them – in addition to the federal credit.

The map below shows the states in orange that offer an R&D Tax Credit. Leyton can assist in the claim of state R&D Tax Credits in addition to the federal R&D Credit.



Leyton R&D Study Process

The Leyton Difference

The Leyton team is made up of highly experienced scientists, engineers, and tax consultants and attorneys. Together we produce innovative and sustainable strategies tailored to each client's unique circumstances. We do this following a multi-step process:

Leyton R&D Study Process

Initial Discussions (1)
- High-level education on the credit
- Discuss company eligibility. Leyton and commercial agreement

Officially Engaged as Client

Initial Assessment (2)
- Determine eligible years to claim
- Estimate credit
- Establish optimal claim timeline

Exploring the Criteria (3)
- Explain qualifying criteria
- Technical lead Q&A with examples
- Finance lead Q&A about qualifying costs

Identification (4)
- Filter technical and financial information
- Identify qualifying projects (R&D vs. routine projects)

Investigation (5)
- Extract detailed technical information
- Begin drafting technical report

Collection (6)
- Gather additional technical info as necessary and relevant cost info

Completion (7)
- Finalize technical report and cost breakdown
- Submission Instructions

The Leyton R&D Study Process unfolds in seven steps:

Initial Discussions – Before the formal engagement begins we seek to understand a company and its goals. In a series of high-level discussions we provide company management with a broad overview of the R&D Tax Credit, the company's potential eligibility, and the role we will play in helping it maximize the benefit.

Initial Assessment – After the company engages Leyton, we formulate a detailed work plan and set out to determine the eligible years to claim the credit and establish an initial estimate of its potential value. In this step, we also agree upon a timeline to deliver the R&D Tax Credit claim.

Exploring the Criteria – In order to better identify eligible projects and expenses we provide the client with a detailed explanation of the qualifying criteria for the credit. As we educate the client about the subtleties of the credit, they educate us about the intricacies of their business. Our Technical Lead on the engagement will work with the appropriate employees to learn about the company's processes so that our research and analysis can be conducted as efficiently as possible, with minimal disruption to the client's business. Our Financial Lead will do the same with the client's accounting staff.

Identification – Armed with this information, we analyze initial technical data and financial information and set the foundation upon which we will build our more detailed investigation model. We will identify projects; delineating those that are routine from potential R&D activities.

Investigation – Our initial identification work informs our more detailed investigation into the technical and financial aspects of the client's R&D activities. As we examine in greater detail specific aspects of certain projects, we memorialize findings and begin to outline the information we gather into what will later become our more formal Technical Report.

Collection – We will continue to gather additional technical information and analyze the cost figures related to it. This is a necessary start to properly support and calculate the R&D claim. We will also continue to build our support documentation as we near completion of our final Technical Report.

Completion – After all of our fact finding, information gathering, and data documentation is completed we create the final Technical Report that will be used to aid the client's tax preparers. The report will be a comprehensive narrative of the company's research and development activities and include detailed analyses of various projects and the specific costs associated with them. In this phase of the project we review the Report with company management and discuss its effect on future R&D studies. We will also provide the client and its tax advisors with instructions for submitting applications for Payroll Tax Credit and/or R&D Tax Credits.

Our process results in the maximum benefit possible with minimum business interruption.

Our technical and financial experts determine eligible R&D projects – historical, current, and expected future – and identify expenditures related to qualifying activities. Our studies make it possible for clients to optimize the amount of their R&D Tax Credit Claim or Payroll Tax credit Claim or both. Our final Technical Report records thorough technical and financial documentation to provide support in defending a client's claim in the event of an IRS audit.

Why Choose Leyton to Assist with your R&D Tax Credit Claim

Global innovation funding specialists

Founded in 1997, Leyton is a global innovation funding consultancy dedicated to helping our clients improve their business performance. In the US, our specific expertise is in federal and state R&D Tax Credits. We use our curiosity and can-do attitude to rapidly identifying and solve challenges, allowing innovation to thrive.

The tax code in the United States is constantly evolving. Leyton uses a dual-approach methodology where both tax professionals and technical specialists with advanced degrees in the hard sciences apply the rules in a holistic fashion to deliver customized solutions for each client. Our knowledge and experience navigating tax laws through every amendment and clarification has led us to be experts on a global scale with insight and understanding that is delivered at a local level.

We constantly monitor market developments to make sure we provide the most current savings solutions and optimization techniques available. We remain continuously up to date on tax litigation and tax legislation in 12 countries around the world. We have helped more than 24,000 clients achieve substantial savings. Our firm completes hundreds of research and development tax claims each month.

24,000 Clients

32 Offices

12 Countries

20+ Years' Experience

1,700+ employees

Leyton works in partnership with each client's outside tax advisors to support their work in the preparation and filing of returns. Our role is to maximize the client's tax credit benefit and provide our clients with a solid foundation of technical analysis and supporting documentation. We do this in a non-invasive manner without disrupting our clients' day-to-day business. Our process ensures that all potentially eligible projects undergo a rigorous scientific and technical assessment, that financial calculations are in full compliance with a jurisdiction's tax legislation, and that claims are fully substantiated.

Conclusion

There are plenty of myths about the R&D Tax Credit, such as that it only applies to large companies from certain sectors. That is far from the truth. Due to these misconceptions, this valuable opportunity is often underutilized and only a third of companies with qualifying activities and expenditures actually claim the credit. In reality, the R&D Tax Credit legislation is much broader than people often realize. As we explained in this whitepaper, almost every industry across the US has significant levels of R&D. Many businesses are unaware that they are doing R&D activity on a daily basis which qualifies them for the R&D Tax Credit.

The tax code itself can be complex and the process of identifying eligible R&D activity can be complicated and technical. And that is why, through a unique combination of tax and technical expertise, we are on a mission to help businesses realize the tax saving benefit of the R&D Tax Credit, irrespective of their size or industry.

As a business, we want to help unleash our client's potential and be a strategic partner in their evolution and growth. We help find openings in processes and ways of working that others can't see, then unlock these opportunities to create value efficiently.

[1]Internal revenue Service, Statistics of Income, Corporation Research Credit, (March 18, 2019).
[2]Internal revenue Service, Statistics of Income, Corporation Research Credit, (March 18, 2019
[3]SBA, Office of Advocacy, Small Business Profile, (2018).
[4]Internal revenue Service, Audit Techniques Guide: Credit for Increasing Research Activities (i.e., Research Tax Credit) IRC §41* – Qualified Research Activities, (June 2005).
[5]Under §41(h) (3) (A) (i), a "qualified small business" has less than $5,000,000 in revenue for the current year and has been in business no more than five years.
[6]Wilson, Dan, Federal Reserve Bank of San Francisco Economic Letter, The Rise and Spread of State R&D Tax Credits, (October 14, 2005).

FAQ

I'm still not sure if I qualify.

Talk to us! Our technical and tax specialists will be able to explain the qualifying criteria to you in detail and then use your projects as a live working example. Even if your business does not currently qualify, at some point that may change, so why not gain the knowledge and insight now for a more promising future?

Will the R&D credit trigger an audit?

If you are submitting an R&D credit on a timely filed return, there is no appreciable increased risk of audit. If you are submitting on an amended return and requesting a refund, there is a slightly increased risk on the order of low single digit percentages.

My business isn't profitable, should I still claim?

It depends. If you are a qualified small business you would be able to claim the payroll credit. If you are not a qualified small business it is dependent upon when you expect to be tax paying. The federal credit can only be carried forward for 20 years. So if there is no projected income tax to pay within 20 years' time, the R&D credit is not worth your while right now.

Can my CPA do this?

Yes they can. The R&D Tax Credit is part of your income tax return that your tax preparer files for you. However, they may not have the technical background and R&D Tax Credit specific experience to ensure you have claimed correctly and to the maximum allowable amount? We find our service is complimentary to that of a CPA. They are generalists in many areas while our focus is solely on the R&D Tax Credit.

What can I do if I've already claimed?

Talk to us! We can work with you to make sure your current credit claim is correct and well substantiated. If you have done it correctly – great! If not, we can help you proceed with the amendment as well as setup best practices for the future.

What does a study entail?

We have evolved our process to make it as time efficient for you as possible. It will require input from you and your team; it is unavoidable! The study will investigate what activities have been performed during the relevant years and to what extent associated expenditure qualifies. To the extent you have documentation readily on hand, your process will be even more efficient from your team's perspective.

My business is a third party contractor. Is my business still eligible?

Potentially, it depends on the nature of your client engagements. It comes down to two questions: "Who bears the financial risk?" and 'Who retains the intellectual property?" The general rule being, the tax payer who bears BOTH the financial risk and retains the intellectual property can potentially claim the R&D credit.

The more important of these two factors is the financial risk. If your business is based on a time and materials basis, there is no financial risk that your business is exposed to so you would not be able to claim for your R&D. Conversely, if you are paid on a fixed fee basis, you can claim for the investment in R&D not covered by the fixed fee. Additionally, if you are paid to create a product, not conduct R&D, you can claim for the R&D investment. This comes down to the wording of contracts, which should be reviewed by a tax attorney.

Intellectual property is also important, but not absolutely critical. If you retain the IP, then you can make a strong case that the R&D is yours; however, even if you do not retain IP, you can likely argue that your business has learned from the client engagement and will now be more efficient for future engagements with similar requirements.

My business contracts significant R&D. Is my business still eligible?

Similar to the answer above, the answer is potentially. Again, you need to look at financial risk and the intellectual property rights, but it will be the opposite scenario. Financial risk is taken on through a time and materials basis, and the original fixed fee. Retaining the IP would also make a stronger case that your business is entitled to claim for the R&D.

Are government contractors eligible to apply?

Many government contractors are eligible to apply for the R&D credit. Supporting regulations and case law tells us that a government contractor can claim the R&D Tax Credit if the research project contract stipulates that the contractor bears the financial risk and retains substantial rights to the research conducted. We can determine who bears the financial risk of research by looking to the research project contract and asking if payment to the contractor is contingent on the success of the research.

Success stories

Industry:
Food Processing

Background
A client of ours makes flavors and flavor delivery systems used in foods and beverages. They routinely devise new flavors, tinctures, and additives. They experiment with production processes and formula combinations to determine the appropriate design of flavor profiles and the optimal method to generate them.

Facts Leyton Identified
Applying principles of food engineering to overcome technical uncertainties qualifies for the credit. The salaries of employees engaged in R&D activities also qualify. We showed them how supplies used in test batches, trial runs, and first-run production could also be considered.

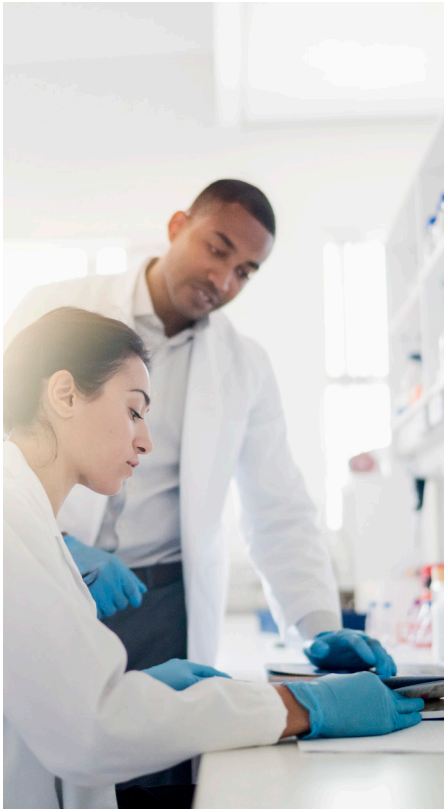
Result
After reviewing current and previous years' activities, we were able to document and claim credits for three prior years. We successfully assisted this client in claiming a $1.3 million R&D tax credit.

Industry:
Medical Device Manufacturing

Background
This client is developing a surgical robot that allows a doctor to perform operations remotely using a virtual reality headset.

Facts Leyton Identified
We staffed the engagement with industry experts who understood the technical aspects of the client's business. They spoke the same language as the client's technical team and were quickly able to identify specific payroll, material, and supply costs that qualified for the credit.

Result
The client provided Leyton with information electronically, allowing the bulk of our work to be conducted in our offices. We turned the project around in a week; well ahead of schedule. Our Technical Report addressed every IRS requirement necessary to substantiate the client's claim. It focused on very specific tax, legal, and technical components of the client's business. Our study produced a huge ROI for them.



Industry:
Craft Brewing

Background

This client produces 40 to 50 unique beers every year. They market a completely new brew, in new packaging, every two weeks. Each batch is the result of a completely scientific process, requiring a molecular understanding of the structure and function of the proteins and nucleic acids that make up the different grains, various spices, yeast, sugar, and dissolved oxygen responsible for a given taste. The biochemical interactions of these ingredients is dependent on the ratio of each and it can take five or more attempts to achieve the desired result.

Facts Leyton Identified

We explained that each time they sought to perfect a new flavor they were actually employing food science technologies. We showed them that each new batch required a unique recipe that was the direct result of the type of experimentation that qualifies for R&D tax credits.

Result

We discovered four years' worth of credits, allowing them to amend both state and federal tax returns. They were so impressed with the savings that they entered into an agreement with Leyton to refer other brewers to us.

Industry:
Wearable Technology Manufacturer

Background

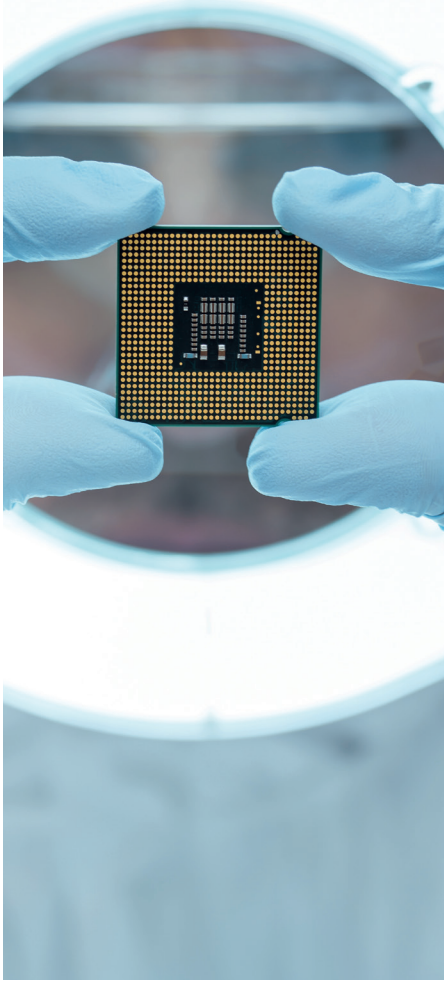
This client produces high technology systems for military personnel and first responders, among others. The products they make utilize WiFi, WiGig, and, Bluetooth componentry and are often custom designed to a buyer's unique specifications. Much of their business comes from the federal government.

Facts Leyton Identified

We observed that most of the client's contracts require it to design, test, and demonstrate multiple prototypes before a product is procured. This routinely puts them at economic risk since the prototypes can be rejected by the government. When this happens, the company must return to the drawing board. All the while, it maintains ownership of any intellectual property created to meet the customer's requirements.

Result

The client's economic risk during the process, and its subsequent retention of IP rights to the technology created, qualifies many of their projects for tax credits. We helped them identify many eligible costs and helped them claim the R&D tax credit for the first time in their existence.



Whitepaper Contributors

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Blake is a Senior Tax Attorney at Leyton with years of experience in providing financial and tax planning advice, technical research, compliance, and federal and state tax incentives. Her areas of expertise include technology, fin-tech, wineries, banking, insurance & investment industries.

Before Leyton, Blake worked at PwC and Deloitte, where she advised on tax strategies and tax structuring for several Fortune 100 clientele. Blake holds an LL.M in Taxation from Boston University and a J.D. from Roger Williams University.

Dr. Craig Hale

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Craig is the Senior Vice President at Leyton with over 10 years of experience in R&D tax incentives. He co-managed Leyton's expansion and growth into the United States and is passionate about helping innovative businesses secure substantial savings through the R&D Tax Credit program in the US.

Craig holds a Ph.D. in Aerospace Engineering from the University of Manchester. His area of expertise include aerospace, aerodynamic acoustics, manufacturing, mechanical engineering, electrical & automotive engineering.

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