Manufacturing MINUTE

R&D Tax Credit Enhancements Provide More Cash-Saving Opportunities for Manufacturers

In December 2015, Congress passed the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), extending and making permanent a number of important tax credits—including the federal research and development (R&D) credit.

The permanent extension of the R&D credit is great news for both manufacturers and the broader U.S. economy: manufacturers can continue to benefit from their investments to attempt to develop or improve their products, manufacturing processes and software; while the broader economy will benefit from the resulting innovation and boost in productivity.

The PATH Act's permanent extension is a welcome change for manufacturers who, according to IRS statistics, accounted for more than $6.5 billion of the total $10.8 billion in federal credits claimed by corporations in 2012. Before the PATH Act, the credit would be passed for a year or two and then expire, leaving taxpayers to wonder, often until their tax year was over, whether they'd be allowed to report a credit for the year. Now, they can consider it a permanent component of their tax planning strategies.

Designed to encourage investment in innovation, the R&D tax credit can sometimes be overlooked by manufacturers who often think that "R&D" is a bar too high to meet.

The U.S. Tax Court, however, has said that "routine engineering" and "routine software development" can qualify; and it and other courts have upheld all sorts of efforts to attempt to make things better, faster, cheaper or greener, e.g., specifying and integrating existing components into an overall design for a new system, evaluating the efficiency of a third party's technology to perform within an existing production process and engaging in scale-up activities to resolve engineering uncertainties not eliminable through testing on smaller processes or equipment.

This is true regardless of what's being manufactured: paper; food; apparel; chemicals; furniture; plastics—it doesn't matter. All of these industry subsectors have reported millions of dollars of R&D credits, and they've enjoyed the tax savings, reduction in effective tax rates and increase in earnings and cash flows that R&D credits can bring.

And with two other changes to the credit, smaller manufacturers have more opportunities to take advantage as well.

For taxable years beginning after December 31, 2015, eligible small businesses can use research credits to offset Alternative Minimum Tax (AMT). An "eligible small business" is generally a privately held corporation, partnership or sole proprietorship with less than $50 million in average annual gross receipts for the three preceding taxable years. Prior to this change (with one exception in 2010), R&D credits could offset only regular tax liability, rendering them of no value in the current year. With the passage of the PATH Act, though, manufacturing companies and their shareholders may receive cash benefits that had been previously inaccessible due to AMT obligations.

R&D Tax Credit Enhancements Provide More Cash-Saving Opportunities for Manufacturers cont...

The second change is beneficial for startup manufacturers. It enables qualified small businesses to offset up to $250,000 of their portion of federal payroll taxes for up to five years. A "qualified small business" is generally a corporation, S corporation or partnership that (1) had gross receipts of less than $5 million for the taxable year and (2) did not have gross receipts for any taxable year before the five-taxable-year period ending with the current taxable year. This enhancement can provide cash savings for startups to continue to invest in innovation, hire personnel and finance new technologies—all activities that align with the credit's original intent.

Now that manufacturers can expect the credit to remain available for years to come, they can more effectively plan their long-term trajectory and make key investments to continue their forward momentum. For those manufacturing companies that have been claiming the R&D credit, now is a great time to make sure nothing is left on the table. Recent changes to what software-development activities qualify have created just one area where re-examination can provide substantial benefits. And for startups and smaller businesses, as we've seen, the new credit modifications offer opportunities that didn't exist previously.

Chai Hoang is a senior associate with BDO's R&D Tax Services practice for the Northeast U.S. region. Chris Bard is the national leader for BDO's Specialized Tax Services Research and Development (R&D) practice.