

Manufacturing MINUTE

How Should Manufacturers Fund Innovation? An Examination of R&D Tax Credits vs. Government Contracts

Imagine this: Company X is a plastics manufacturer attempting to develop new products that can be used in medicine. The company has grown in recent years, generating approximately \$40 million in revenue last year, and has invested heavily in developing biodegradable plastics that can be used for the treatment of bone and bodily injuries and in various other medical procedures, as well as accelerating its 3D printing capabilities to achieve greater scale.

Company X believes it is on the brink of developing a breakthrough biodegradable formula that could be widely adapted in the medical field and is weighing options to fund its ongoing research and development (R&D) activities. Specifically, Company X's management team is evaluating whether pursuing R&D tax credits or a government contract would be most beneficial to its efforts.

To better understand the pros and cons of each option, Company X should ask itself the following seven key questions to determine which option best suits its operations and strides toward innovation:

1. What are the benefits and uses of R&D tax credits?

Enacted in December 2015, the Protecting Americans from Tax Hikes (PATH) Act permanently extended the federal R&D tax credit, better enabling companies to factor these credits into their long-term tax planning. R&D tax credits can result in cash savings of up to 20 percent of qualified spending —potentially more if the qualified activity occurs in certain states.

R&D credits can be used to offset regular income tax liability and, for some smaller businesses and startups, the alternative minimum tax (AMT) and a portion of their payroll taxes. If a company isn't paying taxes, the credits can be carried back one year and forward for 20 years. These credits can reduce a company's effective tax rate, increase its cash flow, improve its earnings per share and provide additional funds for investment in new business opportunities or additional employees.

2. What are the benefits of government contracts?

Cost-reimbursable contracts with the government can minimize financial risk by providing reimbursement for actual costs incurred, plus a profit or fee on top of the costs incurred by the organization. The government will also reimburse a proportionate share of indirect costs, including overhead, general factory expenses and administrative costs. Because these costs generally aren't recovered, having the government pay a share of indirect costs can especially benefit manufacturers.

Further advantages for manufacturers that hold government contracts include developing new customer relationships, expanding and diversifying their client portfolio, unlocking new business opportunities and the potential to receive multi-year, high-dollar contract awards from the government, bringing in additional predictable cash flow.



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3. Am I eligible for contracts or credits?

All manufacturers are eligible to bid on government contracts, unless they have been previously suspended or debarred by the government.

A manufacturer is likely eligible for R&D tax credits if its activities include attempting to develop or improve the functionality, performance, reliability or quality of its products, processes, software, inventions, techniques or formulas.

4. Are there any added benefits of pursuing R&D credits or government contracts for a company of our size?

The PATH Act provides additional opportunities for select smaller companies for tax years beginning after 2015. Eligible small businesses, defined as privately held corporations, partnerships or sole proprietorships with less than \$50 million in average gross receipts for the three preceding tax years can now use the R&D tax credit to offset their AMT.

Additionally, there are certain government funds set aside for small businesses, which are defined by gross receipts or the number of employees, depending on the industry classification of the individual contract. For example, companies performing contracts under NAICS code 325211 (Plastics Material and Resin Manufacturing) with less than 1,250 employees are considered small businesses. If the company meets these criteria, it could bid for certain contracts set aside specifically for smaller businesses.

5. What systems or documentation are required to pursue either opportunity?

No specific supporting documentation is required in order for manufacturers to claim R&D tax credits. While tax examiners may sometimes ask for project accounting records, time-tracking details or other documentation, generally the only requirement is that manufacturers be able to prove expenditures were made and relate to qualified R&D activities. Several court cases have upheld the principle that oral testimony can be relied upon to substantiate a taxpayer's credit.

There are no system requirements for organizations prior to winning a government contract. However, before submitting the first invoice to the government, manufacturers must implement a cost accounting system to track costs by contract, as well as a procurement system documenting the justification of source selections and monitoring subcontracts. Certain requirements may also be unique to each contract, and companies should fully understand what these are prior to submitting invoices to the government.

6. What happens if our company is approved for credits or wins a contract?

If Company X is approved for R&D tax credits, the biggest benefit is offsetting tax liability. Once the company claims R&D tax credits, it has set the foundation for doing so again in the future because its qualified expenditures and activities have already been identified, and the processes for claiming them already established.

If Company X wins a government contract, it will need to deliver the statement of work in a timely fashion. In addition, because it hasn't held a government contract before, it will need to implement the systems described above and any others defined in the contract. Ideally, all costs would be recovered, including the costs of implementing a compliance framework. Furthermore, the company could enjoy the added benefits of contracting experience and increasing its profile in the government contracting industry.

7. Is it possible for a manufacturer to use both a government contract and R&D tax credits?

It is possible that a manufacturing company could both win a government contract and claim R&D tax credits. If the contract provides that the company is both at economic risk for its R&D activities and is allowed to use the results of the research or retain substantial rights to the results, then the company is also entitled to a credit.



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On the other hand, if the agreement states that the government will pay the company whether or not the research succeeds, or if it provides the government exclusive rights to use the results of the research, then the research is considered “funded” and does not qualify for the credit.

With a thorough consideration of these questions, Company X should now be well on its way to identifying the cost-offsetting method that best fits its activities. While Company X exists only in the hypothetical sense, any manufacturers that are attempting to develop or improve their products, processes or software should consider exploring whether R&D tax credits or government contracts can help them along the path of innovation and improve the return on their investment.

This article has been adapted from a piece that originally ran in AccountingWEB.

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