Research credits can make innovation less taxing

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Innovation is a necessity, not a choice, for technology businesses. Organizations constantly strive to achieve a competitive advantage by creating new products, processes and technologies.

To ease the financial burden of tech development, the federal and state governments offer research tax credits. “These programs can have a tremendous impact on a small company’s cash flow and on the firm’s ability to survive,” said Bryson Bailey, senior consultant at the Tri-City Industrial Development Council.

Kathryn Rightor, chief financial office of InnovaTek, called the state’s high tech incentives “a critical factor” in the Richland firm’s decision to locate in Washington.

Mid-Columbia technology entrepreneurs attending a meeting last month of the Three Rivers Venture Group received an overview of the programs from Darren Szendre of Grant Thornton LLP, Portland, and Kim Pietrok of Strategic Business Solutions, Kennewick.

Federal program

The federal research tax credit is designed to encourage innovation by rewarding firms that continuously increase their research efforts. “The government gives a break to companies that take the risks associated with research because innovation leads to new products, new jobs and a healthy economy,” Szendre said.

The taxpayer, such as a corporation, partner or investor, can receive a credit of up to 20 percent on taxes due, depending on current and past research spending.

Szendre said that taxpayers typically must document research activities going back to 1984--the cut-off date Congress selected--or the year the company started.

Because preparing a successful claim is lot of work, Szendre advised companies start with a “research inventory.” “If you answer ‘yes’ to any of the following questions, you may be able to realize significant tax savings through the federal research credit program,” he said.

- Do you develop new products?
- Have you enhanced your production processes in recent years?
- Do you rely on engineers and other technical personnel, either as employees or on a contract basis?
- Do you develop prototypes?
- Have you obtained new patents in recent years?
- Have you implemented a sophisticated software system?
- Have you implemented an International Organization for Standards certification process?

To qualify, the research activity must clearly meet four basic tests. First, there must be "uncertainty" in that the research is being conducted to develop a capability, method or design.

“You don’t get tax relief for doing something that’s already been done,” Szendre said. For example, acquiring a new software program doesn’t qualify; developing a new software program probably would.

The activity also must involve a process of experimentation and be technological in nature. Last, the intent must be for a “new or improved functionality.” There are additional tests for internal use software, plus some exemptions.

Within these activities, many kinds of expenses meet the requirements: salaries, supplies, studies, development up to production and more. “Remember all the people who support a project -- president, direct supervisors, sales, accounting and other contributors,” Szendre said. The calculation can include salaries and other items in proportion to the individuals’ support of the research effort. Depreciable items, such as permanent buildings and equipment, do not qualify.

Other items that don’t qualify include commercialization, reverse engineering, fringe benefits and externally funded research. Szendre explained that funded research is excluded because eligibility for the tax credit “goes to the supplier of the money, not to the spender.”

State program

Washington State offers two kinds of tax relief for research investment – deferral and credit. Both apply to research and development conducted in five areas: advanced computing, advanced materials, biotechnology, electronic device technology and environmental technology.

Businesses can use the high tech credit to deduct up to $2 million annually from their business and occupation tax bill. To quality, research spending must exceed 0.92 percent of revenue for that year. As with the federal program, expenses must be incurred directly for R&D activities.

The high tech deferral allows for a seven-year delay in the payment of sales and use taxes for such items as computers and software, laboratory equipment and instrumentation.

Both state programs are due to expire in 2004. “Several groups are working to maintain these incentives,” Pietrok said.

IRS hot button

While requirements and procedures vary among programs, Szendre and Pietrok agreed that proper documentation is critical for supporting a claim with taxing authorities.

Szendre recommends that firms keep a binder for every project that shows who worked on the job, what they were doing and how that activity meets each requirement for qualification. “If you’re audited, give the IRS your binder.”

The Three Rivers Venture Group meets the third Tuesday of every other month at the Richland Community Center to hear from successful entrepreneurs and other business experts. Pacific Northwest National Laboratory started the group in 1999 to help strengthen and diversify the Tri-Cities’ tech economy. For more information, see http://www.pnl.gov/edo/business/.