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Tax Reform and R&D Credits:

Opportunities for Manufacturers in Federal and International Taxation

25 Sharpe Drive . Cranston, Rhode Island, 02920 . 401-751-0160 . www.rimanufacturers.com

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This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any transaction.

Agenda

- Tax Cuts and Jobs Act Summary
- International Tax Opportunities
- R&D Tax Credits

Tax Cuts & Jobs Act

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Peter Gervais, CPA, CFP®, MST

- Partner at DiSanto, Priest & Co.
- Member of several esteemed CPA associations
- Presenting on:
  - Key business provisions from the Tax Reform
  - Effects on pass-through entities
  - Effects on business owners

Email: pgervais@disantopriest.com
Phone: 401.921.2000

Tax Cuts & Jobs Act

Presented by: Peter Gervais

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➢ Tax Cuts & Jobs Act Agenda

- Important dates
- Corporate reform
- Individual reform
- Planning considerations

Overview of Important Dates

- The Tax Cuts and Jobs Act was signed into law by President Trump on December 22, 2017
- Provisions are generally effective after December 31, 2017
- Most changes in the bill are temporary and scheduled to sunset at the end of 2025

➢ CORPORATE TAX REFORM

Changes to Corporate Taxes/Rates

- Reduction in the corporate tax rate from a maximum of 35% to a flat rate of 21%
- Repeal of the Corporate AMT Tax
- R&D Tax Credit is preserved

CORPORATE TAX REFORM - DEPRECIATION CHANGES

Section 179

- Increased amount that can be expensed to $1 million and increased the phase-out threshold to $2.5 million
- Expanded the definition of qualifying property – roofs, HVAC property, fire protection and alarm systems, etc.

Bonus Depreciation

- Rules for bonus depreciation apply effective September 28, 2017
- New, original use assets placed in service up to September 27, 2017 are eligible for 50% bonus depreciation
- Assets, including used property, acquired and placed in service after September 27, 2017 and before January 1, 2023 are eligible for 100% bonus depreciation
- Starting January 1, 2023 the bonus depreciation rate decreases to 80% and will continue to decrease by 20% in each succeeding year until fully phased out at the end of 2026

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➢ CORPORATE TAX REFORM

- The Domestic Production Activities Deduction, also commonly referred to as the manufacturer's deduction, has been repealed
- New disallowance of net interest expense in excess of 30% of the business's adjusted taxable income; excess interest is carried over indefinitely. There are limited exceptions to this, including businesses with average annual gross receipts of less than $25 million for the three preceding years
- Business deduction for entertainment is denied

➢ CORPORATE TAX REFORM

Accounting Method Changes for Small Taxpayers

- Small taxpayers are those with average annual gross receipts for the three preceding tax years of less than $25 million

- These businesses now have the potential to:
  - Use the cash method
  - Be exempt from the requirement to maintain inventory
  - Be exempt from the uniform capitalization rules found in Code Section 263A

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INDIVIDUAL TAX REFORM

Tax Rate Matters

- Still seven tax brackets, with a decrease in rates and widening of the brackets
  - 2017 rates: 10%, 15%, 25%, 28%, 33%, 35% and 39.6%
  - 2018 rates: 10%, 12%, 22%, 24%, 32%, 35% and 37%
- Dividend and capital gains rates were not changed
- The 3.8% tax on net investment income and the .9% Medicare payroll tax were not repealed
- Individual AMT was not repealed, but the exemption amounts have been increased

Individual Tax Reform

- Increase in standard deduction to $24,000 for married couples filing jointly, $18,000 for head of household and $12,000 for singles and married couples filing separately
- Elimination of personal exemptions

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➢ INDIVIDUAL TAX REFORM

Itemized Deductions Changes

- Repeal of overall limitation on itemized deductions
- New $10,000 limit on the deduction for state and local income taxes and property taxes
- Mortgage interest limited to $750,000 of debt. Applies to debt after December 15, 2017. Debt prior to that point is grandfathered under the old rules
- Home equity interest is no longer deductible
- Elimination of miscellaneous itemized deductions subject to the 2% of AGI limitation

➢ INDIVIDUAL TAX REFORM

New 20% Pass-Through Income Deduction

- Allows for a deduction equal to 20% of Qualified Business Income with respect to each qualified trade or business
  - Qualified Business Income does not include investment income or reasonable compensation paid from S-corporation or guaranteed payments paid to a partner
  - Qualified trade or business does not include "Specified Service Trades or Businesses"
  - A specified service trade or business is any trade or business involving the performance of services in the fields of health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, brokerage services, investing and investing management, trading or dealing in securities, partnerships interest or commodities, or any trade or business where principal asset is the reputation or skill of 1 or more of its employees or owners

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➢ Individual Tax Reform

New 20% Pass-Through Income Deduction

- Deduction is subject to phase-out limitations based on taxable income

- Limitations are based on:
  - Amount of qualified business income
  - Allocable share of W-2 wages from the business
  - Allocable share of unadjusted basis of all qualified property

Deduction makes the effective rate on pass-through income 29.6% (37% x 80%)

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➤ INDIVIDUAL TAX REFORM

Estate and Gift Tax Changes

- The estate and gift tax exemption has been doubled for 2018 to approximately $11.2 million

- The gift tax annual exclusion has been increased to $15,000 per donee for 2018

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PLANNING CONSIDERATIONS

- Evaluation of choice of entity:
  - There is no one size fits all. Choice will be based on facts and circumstances. Need to consider items such as:
    - Exit strategy
    - Eligibility for new 20% deduction
    - Willingness to re-invest profits into business in lieu of distributions
- Debt structure to avoid interest deduction limitation
- Planning around disallowance of entertainment expenses
- Estate/gift planning around increased exemption

Agenda

- Tax Cuts and Jobs Act Summary
- **International Tax Opportunities**
- R&D Tax Credits

International Tax Opportunities

Kevin Kiernan, CPA, MST

- Director of International Tax at DiSanto, Priest & Co.
- Led international tax functions for several U.S.-based, multi-billion dollar corporations
- Presenting on:
  - Effects on federal and international taxation
  - Repatriation of foreign earnings
  - Dividends received deductions
  - Export Incentives

Email: kkiernan@disantopriest.com
Phone: 401.921.2000

International Tax Opportunities

Presented by: Kevin Kiernan

➢ International Tax Opportunities Agenda

- Change to hybrid territorial tax system
- Mandatory repatriation tax
- New focus on non-routine returns – GILTI and FDII

➢ CHANGES TO HYBRID TERRITORIAL TAX SYSTEM

- Adoption of dividend participation exemption system
- 100% dividends received deduction (DRD)
- U.S. corporate shareholders of specified foreign corporations (SFC)
- SFC = 10% owned foreign corporation
- Applies only to C-corporation U.S. shareholders
- Pass-throughs and individual shareholders still subject to tax
- Hybrid system as Subpart F and Section 956 investment in U.S. property rules still apply to greater than 50%-owned foreign corporations (CFCs)
- Added new deemed inclusion similar to Subpart F for CFCs called "GILTI" designed to impose additional U.S. tax on non-routine income earned in low-tax context

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➢ MANDATORY REPATRIATION TAX

- U.S. tax on "locked out" foreign earnings kept offshore
- Reduced U.S. tax burden
- One-time tax on accumulated foreign earnings and profits (E&P) of SFCs
  - Net of E&P deficits
- Applies to all U.S. shareholders of a SFC – Includes U.S. individuals and pass-throughs
- Inclusion year for U.S. shareholder based on last tax year of foreign corporation beginning before January 1, 2018 (transition year)

➢ MANDATORY REPATRIATION TAX

- Reduced U.S. tax achieved by providing deduction (DRD) for exempt portion of deemed inclusion
- E&P held in cash and other liquid assets taxed at 15.5%
  - Thus, exempt portion is 19.5%/35% or 55.71%
- Residual E&P taxed at 8%
  - Thus, exempt portion is 27%/35% or 77.14%
- C-corporation shareholders entitled to deemed paid foreign tax credits for taxable portion (i.e. proportional disallowance for exempt portion)

➢ MANDATORY REPATRIATION TAX – TIMELINE FOR PAYMENT

- Election available to pay tax over 8 years, no interest
  - 8% - years 1-5
  - 15% - year 6
  - 20% - year 7
  - 25% - year 8

- Special election available for S-corporation shareholders to defer payment of tax until one of the following triggering events occur:
  - The termination of the corporation's subchapter S election;
  - The liquidation or sale of substantially all of the assets of the corporation; or
  - A transfer of the corporation's stock by the shareholder

International Tax Opportunities

Presented by: Kevin Kiernan

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➢ New Focus on Non-Routine Returns

- CFC's with Global Intangible Low-Taxed Income ("GILTI")
- U.S. with Foreign-Derived Intangible Income ("FDII")
- Deemed Tangible Income (or Routine Return) = 10% Return on Depreciable Tangible Assets
- Deemed Intangible Income = Anything in Excess (or Non-Routine Return)
- Tangible Assets = Qualified Business Asset Investment ("QBAI")
  - Used in trade or business
  - Depreciation allowable under Sec. 167
  - Tax basis determined under Sec. 168(g) ADS

FDII – NEW EXPORT INCENTIVE FOR GOODS AND SERVICES

- Available to U.S. C-corporations only
- New deduction for "foreign derived intangible income" ("FDII")
- Reduces U.S. corporate tax rate from 21% to 13.125% on FDII by allowing new deduction for 37.5% of FDII
- Despite its name, this new incentive is available to companies for:
  - The sale of goods (includes licenses and leases) to foreign persons for use outside the U.S., or
  - The performance of services for foreign persons or with respect to property outside the U.S.

➢ FDII – NEW EXPORT INCENTIVE FOR GOODS AND SERVICES

- Any U.S. C-corporation that sell goods to, or perform services for, foreign customers qualifies

- Calculation requires some effort but essentially involves the following:
  - Determine foreign-derived income ratio = foreign sales/services activity over total sales/services activity
  - Determine deemed intangible income = total income (gross income less allocable deductions) less 10% return on tangible depreciable assets
  - Determine foreign derived intangible income (FDII) = deemed intangible income multiplied by foreign-derived income ratio
  - Compute new deduction for FDII = FDII x 37.5% (decreases to 21.875% after 2025)

GILTI – NEW US MINIMUM TAX ON CFCs

- Applies to U.S. shareholders of CFCs
- Deemed income inclusion similar to Subpart F income
- GILTI = Net CFC tested income – Net deemed tangible income return
- Separate FTC Basket for GILTI

GILTI – NEW US MINIMUM TAX ON CFCS

- For U.S. C-corporation Shareholder
  - 10.5% US tax rate after new 50% deduction for GILTI
  - Deemed paid credits allowed at 80%
  - No residual US tax if foreign tax = > 13.125%
  - 50% deduction will decrease to 37.5% after 2025

- For U.S. Individuals and Pass-Throughs
  - Could have significant US tax consequences
  - Taxed at higher marginal individual tax rates
  - No 50% deduction – C-corporation only
  - No deemed paid credits

Agenda

- Tax Cuts and Jobs Act Summary
- International Tax Opportunities
- **R&D Tax Credits**

R&D Tax Credits

- Partner at Anchin, Block & Anchin LLP
- Leads Anchin's Research & Development (R&D) Tax Credits Group
- Presenting on:
  - History of R&D Tax Credits
  - Qualification criteria
  - Calculation methods
  - Case studies
  - Key changes in 2018

Yair Holtzman, CPA, MBA, MS, CGMA

Email: yair.holtzman@anchin.com
Phone: 914.860.5599

R&D Tax Credits Agenda

- History and Overview of the Research Credit
- Research & Development Tax Credit
- Manufacturing Industry Examples
- Case Studies
- How Do You Calculate the Credit?
- Legislative Updates
- Anchin's R&D Tax Credits Group
- Questions

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IRC § 41: History and Overview

- IRC Section 41 research and development (R&D) tax credit is a general business credit provided to companies that perform R&D activities in the U.S.
  - Tax incentive to increase research spending over the amount a company would be expected to spend on research
- Enacted as a temporary credit in 1981 to stimulate research and development activity
- Research credit permanently extended by PATH Act of 2015
  - No changes with The Tax Cuts and Jobs Act of 2017

R&D TAX CREDITS

Presented by: Yair Holtzman

IRC § 41: HISTORY AND OVERVIEW

- Immediate source of cash
- Tax credit more valuable than a deduction – $1 for $1 reduction of tax liabilities
- Innovation enhances competitiveness and increases efficiencies
- Federal R&D tax credits may be carried back 1 year and forward for up to 20 years
  - Retroactive claims on amended returns (available for open tax years)
- State R&D tax credits are currently available in 36 states
- R&D tax credit lowers a company's effective tax rate
- R&D tax credits refuel the research and development cycle

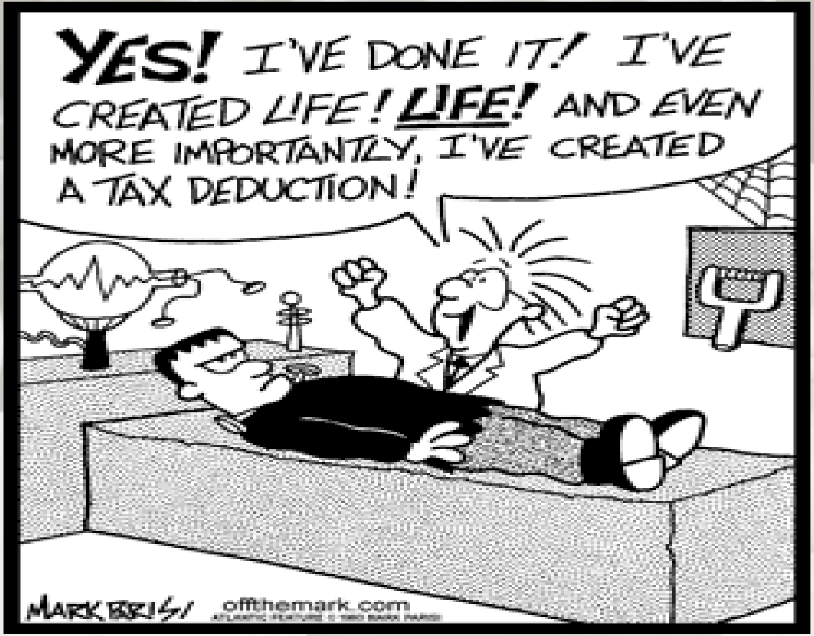
➤ IRC § 41: History and Overview

Several States Provide

- Refundable credits
- Ability for unused tax credits to be used by affiliates and/or transferred or sold to other entities
- Additional credits related to R&D

What Activities Qualify for the R&D Tax Credit?

➢ What is Qualified Research?



➢ WHAT IS QUALIFIED RESEARCH? – THE "FOUR-PART TEST"

Permitted Purpose

- Must relate to a new or improved business component's:
  - Function
  - Performance
  - Reliability
  - Quality

Technological in Nature

- Must fundamentally rely on principles of:
  - Engineering
  - Biological Science
  - Computer Science
  - Physical Science

➢ WHAT IS QUALIFIED RESEARCH? – THE "FOUR-PART TEST"

Technical Uncertainty at the Outset

- Uncertainty exists if the information available does not establish the following:
  - Capability or methodology for developing or improving the business component
  - Appropriate design of the business component

"Your proposal is innovative. Unfortunately, we won't be able to use it because we've never tried something like this before."

Process of Experimentation

- All of the activities must be elements of a process of experimentation to eliminate technical uncertainty:
  - Evaluation of alternatives
  - Confirmation of hypotheses through testing and/or modeling
  - Refining or discarding of the hypotheses

R&D Tax Credits

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- "We don't do any R&D here"

➢ SUMMARY – TYPES OF QUALIFYING ACTIVITIES

New Product Development

Incremental Product Improvement

R&D

New Process Development

Incremental Process Improvement

New or Incremental to the Taxpayer – Not to the Industry!

➢ R&D TIMELINE – WINDOW OF OPPORTUNITY

IDEATION COMMERCIALIZATION

Post-Commercialization Exceptions

- 6 σ
- Lean
- TQM/JIT
- Process Improvement

Non-Qualifying Activities

- Research including contract research conducted outside the United States, Puerto Rico, or other U.S. possessions
- Research after commercial production
- Research where the taxpayer does not retain substantial rights
- Research related to management functions or techniques, surveys, routine collection of data
- Research related to style, taste, cosmetics, or seasonal design factors
- Adaptation of an existing product to a particular customer's requirement or need, without any uncertainty present
- Reverse engineering

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Manufacturing Industry Examples And Case Studies

GENERAL QUALIFYING ACTIVITY EXAMPLES – PRODUCT MANUFACTURING

- Developing next-generation or improved products
- Designing or improving on tooling
- Developing unique computer/IT integration in manufacturing
- Designing innovative manufacturing equipment and tools
- Prototyping and three-dimensional modeling and/or CAD design

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GENERAL QUALIFYING ACTIVITY EXAMPLES – PROCESS MANUFACTURING

- Designing and developing innovative operational processes
- Increasing throughput, reducing waste or spoilage
- Integrating new materials to improve product performance and manufacturing processes
- Determining tooling requirements
- Designing and evaluating process alternatives
- Designing, constructing, and testing product prototypes
- Developing processes that would meet increasing regulatory requirements
- Streamlining manufacturing processes
- Increasing manufacturing capabilities
- Developing new applications
- Improving product quality
- Improving yields and throughput
- Reducing manufacturing times
- Optimizing manufacturing processes
- Designing for manufacturability
- Designing for scale-up

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➤ SPECIFIC QUALIFYING ACTIVITY EXAMPLES – MANUFACTURING

- Design and development of new products or processes
- Improvement/modification of products by enhancing performance, functionality, reliability or quality
- Manufacturing process improvements through implementation of techniques or automation technologies for higher quality products, better yield, reduced waste/scrap, improved safety or environmental friendliness
- Design and development of specialized manufacturing equipment, tools, molds, jigs or dies
- Concept ideation, formulation, feasibility analysis or prototype development/testing

Specific Qualifying Activity Examples – Manufacturing

- Materials evaluation – testing, analysis and selection
- Implementation or use of computer aided tools, 3D modeling or robotics
- Contract manufacturing and fabrication
- Design of new or improved packaging or packaging systems
- Design and development of hardware or software systems used in production or manufacturing
- Development of applications for technology patents

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➢ CASE STUDY 1

- Company desired to develop new technology and heating element for use in consumer cooking products that was faster than the conventional oven or microwave
- It was uncertain at the start of the project whether any developed technology could outperform traditional heating and cooking technology
- It was also uncertain if the company could meet necessary safety requirements for the new product
- Company investigated optimal product design and experimented with various types of materials, sizing and tooling

CASE STUDY 1 (CONTINUED)

- Multiple tests were designed and conducted to test taste, texture, consistency and nutritional content of food prepared using the new cooking technology
- Company also investigated issues regarding tooling oxidation and corrosion, power applications and manufacturing technology
- After extensive analysis of the expenditures and activities involved in this project, it was determined to qualify for purposes of the R&D tax credit

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➢ CASE STUDY 2

- Company developed a new coconut water beverage product based on findings that consumers prefer the taste of young green coconut water over mature coconut water
- The goal was to improve the taste of mature coconut water that is 66% less expensive and in plentiful supply compared to young green coconuts
- Company tested the mineral content of both young and mature coconut water and found that the sodium content was 6-8 times higher in the coconut water from mature coconuts and was the main driver for the difference in taste
- Company conducted in-house bench scale trials of ion exchange resin to first resin acidify and then resin de-acidify mature coconut water and measured the effect on sodium content

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➢ CASE STUDY 2 (CONTINUED)

- Company hired an ion exchange equipment manufacturer to build test equipment and conduct trials on reducing sodium content using ion exchange resins
- Company also conducted trials using electro dialysis to remove sodium and other electrolytes, tested the resulting product for mineral content, found that all minerals were depleted
- After extensive analysis of the expenditures and activities involved in this project, it was determined to qualify for purposes of the R&D tax credit

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➢ CASE STUDY 3

- Company designed a new, innovative manufacturing, production and distribution facility for its millwork and fabrication business. It's goal was to maximize efficiencies within a relatively small footprint

- A unique solution developed was a 100'+ high, double deep rack storage system, including design of custom shipping carts capable of being stacked and which can be safely forklifted up to any location in the storage system. A Radio Frequency Identification (RFID) solution was developed to show the exact contents and location of every shipping cart within the facility

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➢ CASE STUDY 3 (CONTINUED)

- Design of the new facility required integration of all new woodworking machines, and new control software to ensure that raw materials are stored and pulled in the most efficient manner possible, thereby increasing throughput and reducing waste on each of the facility's production lines

- Finishing lines were also reorganized and improved and a mock-up room was strategically designed and located to allow for viewing of individual job components prior to mass production

What Expenses Qualify for the R&D Tax Credit?

➢ How is the R&D Tax Credit Calculated?

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Drivers of the Calculation – Qualified Research Expenses

Qualified Employee W-2 Wages

- Who Qualifies?
  - One step up and one step down from project experimentation
- Supervision of R&D
  - Department heads, strategists
- Direct R&D
  - Project experimentation
  - Engineers, software developers, scientists, most technical personnel
- Support of R&D
  - Data gathering, report writing / analysis, testing, determination of specs & requirements, QA, some equipment maintenance / improvements

DRIVERS OF THE CALCULATION – QUALIFIED RESEARCH EXPENSES

Qualified R&D Supply Expense

- Includes:
  - Materials consumed in experimentation for NPD
  - Materials used for building product prototypes
  - Materials used for generating samples during NPD
  - Materials consumed in trial runs / failed batch trials
  - Waste, scrap, spoilage from manufacturing
- Excludes:
  - Capitalized equipment
  - Overhead (electricity, heat, insurance, etc.)

Drivers of the Calculation – Qualified Research Expenses

Qualified R&D Contract Research Expense*

- Outside consultants/vendors hired on behalf of the taxpayer
  - Research or development activities must take place in the US
  - Activities must qualify per IRC Section 41
  - Taxpayer must be liable for payment regardless of outcome
  - Taxpayer must retain substantial rights to research results

**Allowed at 65% of expense*
**Allowed at 75% for expenses paid to qualified research consortia (primarily non-profits and universities)*

How Do We Calculate the Credit?

- Two methods exist to calculate the credit for taxpayers who conduct qualified research:
  - Traditional regular research credit
  - Alternative simplified credit (ASC)

- ASC is beneficial to companies that have not reported research credits in the past or have reported nominal credits due to burdensome base amount rules

ASC VERSUS REGULAR CREDIT

	Alternative Simplified Credit	Traditional Research Credit
Statutory Credit Rate (Effective Credit Rate)	2007 & 2008 –12% (7.8%) 2009—14% (9.1%)	20% (13%)
Base Amount	Indexed to QREs: 50% of the average QREs in the 3 years prior to the credit year	Indexed to GRs:FB% (ratio of QREs/GRs in 1984-1988)* average GRs in the 4 yrs prior to the credit year
Minimum Base Amount	None	50% of credit year QREs
Maximum Base Amount	None	FBP cannot exceed 16%

RHODE ISLAND RESEARCH EXPENSE CREDIT

- Credit available to corporations, sole proprietors, or passed through from partnerships, joint ventures or subchapter S-corporations for QREs
- The credit is calculated on the excess of qualified research expenses over the base amount that occurred in Rhode Island
  - The credit is 22.5% on the amount of excess expenses up to $111,111 and 16.9% for the remaining expenses over $111,111
  - Credit is limited to 50% of the tax liability payable after all other credits have been used
- Definition of QREs follows IRC §41
- Credit is non-refundable and can be carried forward for 7 years

STATE RESEARCH CREDITS

- In addition to the Federal R&D tax credit, State research credits are currently available in 36 states including:
  - Rhode Island - calculated as 22.5% of the first $111,111 of excess RI current tax year QREs over Base Amount (average of the three preceding taxable years), and then 16.9% of any remaining RI current tax year QREs over Base Amount
  - Connecticut - has two research tax credits available to taxpayers
    - Form CT-1120RC – calculated by taking 20% of the incremental increase in CT QREs that exceeds the amount spent during the previous income year
    - Form CT-1120RDC – calculated by taking 6% of current year CT QREs
  - Massachusetts – calculated as 10% of the incremental MA QREs over Base Amount. If no QREs in any 1 of 3 prior taxable years, the credit is equal to 5% of the taxpayer's QREs for the taxable year

Legislative Updates

➢ PATH Act of 2015

Tax Law Change	Implications for Taxpayers
1. Permanency	• Tax planning opportunity to lower effective tax rate
2. Taxpayers with gross receipts of less than $50 million allowed to take R&D tax credit against their AMT liability	• Starts in 2016 tax year • Cannot apply carryforward credits against AMT
3. Businesses with no tax liability and gross receipts of less than $5 million a year can utilize the credit against payroll taxes	• Starts in 2016 tax year • Unprofitable small start-ups can now take advantage of the R&D tax credit

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PATH ACT – TAXPAYERS SUBJECT TO AMT

- What is the alternative minimum tax (AMT)?
  - AMT is a supplemental income tax required in addition to baseline income tax for certain taxpayers that have exemptions or special circumstances allowing for lower payments of standard income tax
- For tax years beginning after 2015, eligible small businesses (ESBs) can take the R&D credit against their AMT liability
- ESB is defined as a private corporation, a partnership, or a sole proprietorship with average annual gross receipts for the three-taxable-year period preceding the current taxable year not to exceed $50M
  - Partners of a partnership and shareholders of an S-corporation must also separately meet the gross receipts requirement

R&D Tax Credits

Presented by: Yair Holtzman

➢ PATH Act – Payroll Tax Offset

- For tax years beginning after 2015, qualified small businesses (QSBs) will be able to use the R&D tax credit to offset payroll tax
- QSB defined as a business with less than $5M in annual gross receipts and having gross receipts for no more than five years
- Provides cash flow opportunity for small start-up companies that have no currently tax liability to offset the R&D tax credit
  - Makes an otherwise non-refundable R&D credit refundable
- Maximum benefit – $250,000

Why R&D Credits at Anchin?

- Not only CPAs and JDs but also scientists and engineers
- Senior level individuals involved in day-to-day activities of engagements
- All former Big 4 personnel and substantially less expensive than Big 4 firms
- Work hand-in-hand with other CPA firms
- Perform work on site
- Contemporaneous model, studies done in real time
- Sustainability record on IRS exam is 98.4%
- We are involved in studies in a range of different capacities: from completing a study from start to finish, to developing R&D tax credit study tools, to qualitative or quantitative review
- 100% retention of client base

Questions?