

"The role of government is not to create wealth; the role of our government is to create an environment in which the entrepreneur can flourish, in which minds can expand, in which technologies can reach new frontiers."

- President George W. Bush

alliantgroup

The Research & Development Tax Credit

Presented By:

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Managing Director
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Agenda

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- An Overview of the Opportunity
- A Technical Overview of the Basic R&D Rules
- Recent R&D Engagements / Results
- Why Conduct An R&D Study Now?
- What to Look for?
- The Firm's R&D Tax Services Group
- The Approach
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Introduction

- Gregory Bratcher - Managing Director
- The **alliantgroup** is an independent national professional services firm focused on delivering R&D tax credit services
- **alliantgroup's** Managing Directors consist of former Big 4 Accounting Firm partners, Law Firm Partners, IRS members, software developers and engineers.
- The company's national office is in Houston, Texas with other offices in San Francisco, San Diego.
- Expanding into Atlanta, Chicago, Detroit, DC, LA, Miami, New York, and Seattle in 2004

The Opportunity

- If your company has invested time, money, and resources to the advancement and improvement of your company's products or processes, then you likely have qualifying research under the Federal R&D Tax Credit / Incentive Program.
- **Are you taking advantage of all of the research and development credits available?**
- **The R&D Tax Credit Opportunity:**
 - **A hidden and immediate source of cash for many companies;**
 - **A significant reduction to current and future years federal and state tax liabilities;**
 - **Over \$5 BILLION in federal R&D tax credit benefits are given out annually;**
 - **Approximately 80% of the \$5 Billion goes to a few of the nation's largest companies;**
 - **Every successful company is potentially eligible for an R&D tax credit of some amount – many companies are unaware that their day-to-day operations can qualify for the R&D Credit;**
 - **The 20% research tax credit is not a deduction. It is an actual dollar-for-dollar credit against taxes owed or taxes paid. Additionally, the taxpayer may be able to expense all such costs in the year incurred;**

The Opportunity

- A business can take the credit for all open tax years – generally the last three or four years plus the current year;
- Additional years may be available if the taxpayer is in a net operating loss or alternative minimum tax position;
- Tax credits may carry forward twenty (20) years;
- Recent tax laws are taxpayer friendly and bring additional benefits;
- In addition to the Federal R&D Tax Credit, there are additional State tax credits.

The Opportunity

- **Congress has provided a tax credit to taxpayers for increased spending on qualified research and development activities (R&D).**
 - ◆ Credit was first enacted in 1981
 - ◆ Tax Credit v. Tax Deduction
 - ◆ Traditional definition of R&D v. *Qualified Research Activity*

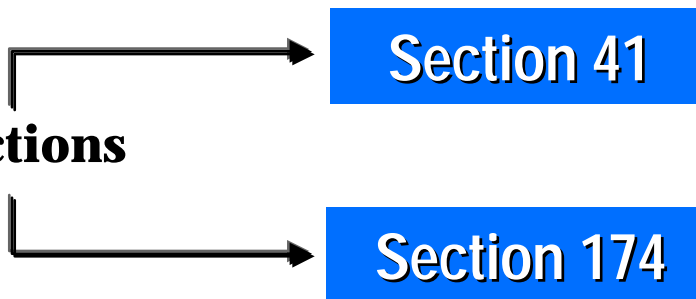
- **Credit is for *increasing* research activities**
 - ◆ Current expenditures are measured over a *base amount*
 - ◆ The *base amount* is currently determined by reference to the taxpayer's 1984-1988 tax years (*base period*)
 - ◆ How much the taxpayer spent on qualified research activity during the *base period* will determine the *base amount* for the credit years

The Opportunity

- **Many companies have under reported qualified research activity, and may be entitled to additional tax credits.**
 - ◆ Eligibility for the tax credit is determined by evaluating the *activity* being performed.
 - ◆ Where the activity meets specified criteria, certain expenditures related to the activity may then be included in calculating the tax credit.
 - ◆ Additionally, activity which directly supports or directly supervises qualified research activity is also qualified activity.
 - » Support can include administrative assistants, technicians, certain maintenance personnel.
 - » Supervision can include direct interaction with personnel performing qualified research activity (first-line management).
 - » Furthermore, if *substantially all* (80% or more) of all the activity is qualified, the taxpayer can include **100%** of the wages associated with that activity.

R&D Tax Credit Basics

- **2 Code Sections**



- **2 Steps to determining the tax credit**

1) Evaluation of Activities

- ◆ Meet with client technical personnel to evaluate qualified research, support, and supervisory activity

2) Determination of Associated Costs

- ◆ Determine which expenditures associated with that activity are eligible for the tax credit

Eligible Costs

■ **Wages**

- ◆ Form W-2 wages
- ◆ Excludes 401(k), benefits, & overhead costs

■ **Supplies**

- ◆ Items used or consumed in the qualified activity
- ◆ Costs to fabricate prototypes

■ **65% of *Contract Research***

- ◆ Where the taxpayer pays someone other than an employee to perform qualified research
- ◆ Fees paid to consultants or engineering firms
- ◆ The Taxpayer must bear the economic risk (funding issue)

Qualified Research—Five Main Requirements

- 1) ***New or Improved Product, Process or Software (Business Component)***
- 2) **Technological in Nature**
- 3) **Elimination of Uncertainty**
- 4) **Process of Experimentation**
- 5) **Permitted Purpose**

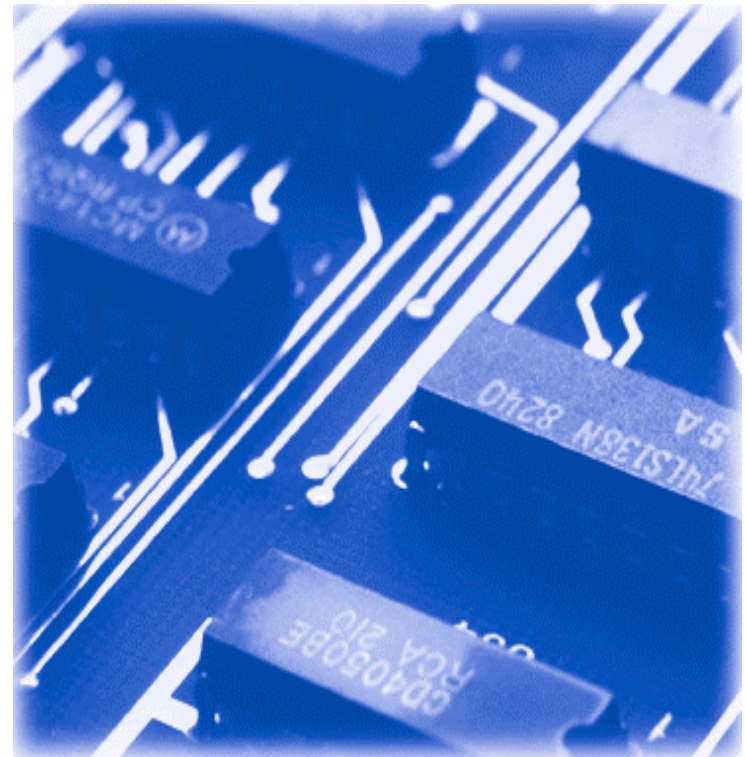


New or Improved Business Component

- **Business component is a...**
 - ◆ Product or process,
 - ◆ Computer software,
 - ◆ Formula, technique, or invention.

- **Activity must relate to a new or improved aspect of the business component**
 - ◆ Improvements can be evolutionary in nature - no requirement that the improvement is *significant*

- **Improvement eligible provided not commercially available for purchase from a third party**



Technological in Nature

- **Research must be undertaken *to discover* information which is *technological in nature*.**

Activity is deemed technological where the process of experimentation relies on the principles of the physical or biological sciences, engineering, or computer science.

Elimination of Uncertainty

- **Treasury Department Regulations require that the research involve uncertainty or risk.**
- **Uncertainty or risk is measured at the outset of the project.**
- **Uncertainty must relate to technological risk not just general business risk.**
 - ◆ Uncertainty as to the design or method of achieving that design will satisfy technological uncertainty.
 - ◆ Failures and changes in course demonstrate uncertainty or risk.

Process of Experimentation

- **Experimentation may be defined as the evaluation of more than one alternative as part of a sequential design process.**
- **For tax credit purposes, documentation of the process of experimentation is critical - including failed experimental efforts.**
 - ◆ Experimentation occurs when the means of achieving the desired objective is not readily discernible at the outset.
 - ◆ Can include trial and error, modeling, and simulation efforts.
 - ◆ For software development, a process of experimentation has been defined as “the process of developing, reviewing, analyzing, and testing the various approaches proposed....”

Process of Experimentation §1.41-4(a)(5)

- **Process to evaluate more than one alternative designed to achieve a result where the means of achieving that result are uncertain at the outset.**

- **Described as a process that:**
 - ◆ develops one or more hypotheses;
 - ◆ includes a scientific experiment to test and analyze hypotheses (through modeling, simulation, or a systematic trial and error methodology);
 - ◆ conducts the experiment and records the results;
 - ◆ refines or discards the hypotheses in a sequential design process to develop or improve the business component.

Permitted Purpose

- **Activity must relate to new or improved...**



■ **Function,**



■ **Performance,**



■ **Reliability or**



■ **Quality**

Internal-Use Software Development Activity

- **In the Tax Reform Act of 1986, Congress stated the criteria to be applied to determine whether internal-use software development would qualify for the tax credit. The proposed regulations issued on 12/31/96 by the Treasury Department include the same three additional tests.**
- **Public hearing held 5/13/97.**
- **In addition to all the other requirements for the credit, internal-use software must also meet three additional tests:**
 - ◆ Innovative,
 - ◆ Significant economic risk, &
 - ◆ Commercially unavailable.



Nonqualified Research

■ **Funded Research**

- ◆ Where the Taxpayer is under contract for qualified research activity, and the Taxpayer's customer has agreed to pay *cost plus* or *time and materials*, the research will probably be considered funded research. Where the customer agrees to pay a fixed price, the Taxpayer's research is not funded.
- ◆ Who bears the economic risk of research failure?

■ **Non-retention of substantial rights is *deemed funded research***

- ◆ The taxpayer must have economic rights in the product of the research.
- ◆ Where the taxpayer has to pay to use the research, the Treasury Regulations state that the taxpayer does not have substantial rights.
- ◆ *Lockheed Martin*- In November 1998, U.S. Court of Federal Claims held government contractors retain insufficient intellectual property rights to qualify for R&D credit; currently being appealed.
- ◆ Amounts received from a more than 50% commonly controlled foreign parent or affiliate to reimburse R&D are not considered funding.

Computation of the Tax Credit

- Calculate *fixed-base percentage*
- Calculate *base amount*
- Calculate *qualified research expenditures*
- Calculate the credit amount



Calculating the 2001 Qualified Expenses

	<i>Total Cost Incurred</i>	<i>Qualified Research Expenses</i>
Wages Subject to Withholding	\$11,000,000	\$11,000,000
Fringe Benefits not Subject to Withholding	1,000,000	0
Supplies	2,500,000	2,500,000
Depreciation	3,000,000	0
Overhead	12,500,000	0
Contract Research	10,000,000	6,500,000*
Total	\$40,000,000	\$20,000,000

**65% of contract research qualifies*

Calculating the 2001 R&D Credit

Qualified Research Expenses	\$20,000,000
Less: Base Amount	15,000,000
Incremental R&D Expenses	5,000,000
Effective R&D Credit %	@ 13%
Federal R&D Credit	\$650,000

Note: *State R&D credit calculations generally parallel federal computation with certain modifications. States usually allow credit only for R&D performed in-state.*

Recent R&D Engagements

■ Horizon Offshore Reports Second-Quarter Results

Date: 08/07/2003

Press Release

Source: Horizon Offshore, Inc.

HOUSTON, Aug. 7, 2003 -- Horizon Offshore, Inc.

(Nasdaq:HOFF) today reported a net loss for the quarter ended June 30, 2003 of \$(4.1) million, or \$(0.15) per share-diluted. This compares with net income of \$2.6 million, or \$0.10 per share-diluted, for the second quarter of 2002.

For the second quarter of 2003, gross profit was a \$(0.8) million loss on revenues of \$57.9 million, compared with gross profit of \$9.5 million, or 14.8 percent, on revenues of \$64.3 million for the second quarter of 2002. Pre-tax net loss was \$(10.3) million, with an income tax benefit of \$(6.2) million for the second quarter of 2003, compared with pre-tax net income of \$3.8 million and an income tax provision of \$1.2 million for the same quarter last year. Included in the tax benefit for the second quarter of 2003 is a research and development tax credit of \$(3.0) million.

Recent R&D Engagements

- *A Privately-Held Chemical Company with \$18 MM in annual revenue - \$1,700,000 of Tax Credits*
- *A Privately-Held Software Development Company with \$5 MM in annual revenue - \$525,000 of Tax Credits*
- **A Publicly traded software developer – \$1.2MM in Incremental Tax Credits on – prior study completed by a Big 4 Firm**

Why Conduct An R&D Study Now?

- Prior to December 2001, the requirements necessary to qualify for the R&D tax credit were rather difficult to obtain. However, in December 2001, the Bush administration issued IRS regulations which apply retroactively and have made it **significantly easier** to qualify for the R&D Tax Credit.
- The new regulations are in harmony with the intent of Congress and are much more taxpayer friendly. They reflect a profound change in the position of the IRS.
- The new regulations make it:
 - **1) easier for a broader array of companies to qualify their activities as R&D;**
 - **2) they provide greater flexibility in certain recordkeeping requirements, and**
 - **3) they significantly expand the definition of internal-use software characteristics.**
- Although we typically can go back three to four tax years, the statute of limitations may bar our ability to go back to the farthest open year if action is not taken as necessary

What Qualifies as R&D?

- Many taxpayers tend to regard "R&D" as an activity associated solely with high-tech, biotech and pharmaceutical type companies.
- We have found many of our clients tend to regard their own efforts to make new, lighter, stronger, cheaper, more reliable products, or to make more precise, more economical and more versatile processes as "just doing my job," when in fact they have been performing R&D qualifying activities all along.
- If your Company is involved in any of the following activities, you may be able to claim the R&D tax credit:
 - **Manufacture products;**
 - **Develop new, improved, or more reliable products / processes / formulas;**
 - **Develop prototypes or models (including computer generated models);**
 - **Design tools, jigs, molds, and dies;**
 - **Develop or apply for patents;**
 - **Perform certification testing;**
 - **Conduct testing of new concepts and technology;**
 - **Development of new technology;**

What Qualifies as R&D?

- Attempt the use of new materials;
 - Add new equipment;
 - Perform environmental testing;
 - Develop or improve production / manufacturing processes;
 - Develop, implement or upgrade systems and / or software;
 - Develop production control software;
 - Improve or build new manufacturing facilities;
 - Automate / streamline internal processes; and
 - Expend resources on outside consultants / contractors to do any of the above stated activities.
- In addition, many taxpayers miss out on qualified R&D expenditures in areas such as manufacturing, engineering, quality assurances, marketing, purchasing and information technology.

The Firm's R&D Tax Services Group

- We have established a team of senior-level specialists located in our National Office “Center-of-Excellence” who focus exclusively on R&D tax issues.
- These specialists include industrial, software, mechanical, chemical, and electrical engineers, attorneys and CPA's.
- We utilize cutting-edge tools, processes, and technologies that allow us to conduct a non-intrusive turnkey R&D study while providing a high quality product deliverable.

The Approach

Phase 1 – Assessment and Feasibility:

- Our work during Phase 1 focuses on obtaining an understanding of your company's business and research and development activities.
- During the Assessment and Feasibility Phase, **alliantgroup** performs preliminary analysis and interviews with key personnel to identify projects, departments, processes, technologies, department leaders, and project managers where potential qualifying research expenditures may be found.
- In addition, we evaluate the type and availability of contemporaneous documentation to substantiate the qualified research expenditures.
- Using the information gathered, we determine the potential tax savings and future benefits of conducting the R&D Tax Credit Study.

The Approach

Phase 2 – Design and Implementation:

- In Phase 2, alliantgroup designs a detailed work plan and executes the associated implementation strategy.
- We interview additional Company personnel, analyze contemporaneous documentation and financial information to finalize the quantitative calculation.
- This phase entails a full analysis of technical issues related to qualified R&D projects, detailed collection of eligible expenditures, and identification, documentation and quantification of qualifying expenditures.

The Approach

Phase 3 – Reporting:

- This phase includes the preparation and delivery of the R&D Study and its quantitative and qualitative components, which will serve as the Company's documentation supporting the R&D tax credits claimed.
- The Reporting phase also includes the preparation of the required amended tax returns. The R&D report is designed and organized to allow for a clear audit trail for the IRS.

The R&D Study / Technical Report

- The R&D Study / Technical Report is where all the arguments, documentation of qualification and quantification must coalesce into a coherent statement of who, why, when, where and how much. The Study will convey the credit being taken and the basis for such amount. For a credit with varying qualitative issues, the report is critical.

CHEMCO RESEARCH & DEVELOPMENT TAX CREDIT STUDY FOR THE YEARS 1998 THROUGH 2002

1.0 RESEARCH & DEVELOPMENT TAX CREDIT STUDY FOR [REDACTED]

1.1 Executive Summary

alliantgroup was engaged by [redacted] to substantiate and document the Company's ("RAD") activities in accordance with the "R&D" or "CR&D" sections 41 and 174 of the Internal Revenue Code of 1986, [redacted] Treasury Regulations, and [redacted] not an opinion letter and it should not be construed as such.

This Research and Development Tax Credit ("RAD Study") is a new implemented cost center approach and a project-by-project assessment of the availability and utilization records and our assessment as to how it Company's RAD activities.

This RAD Study covered [redacted]'s cost from January 1998 through December 2002.

The benefits [redacted] has realized as Development Tax Credit Study are as follows:

- Realized approximately \$[redacted] million savings and financial statement benefits.
- May realize additional tax savings in the future.
- May increase the market value, earnings per share, and other financial metrics.
- May lower the Company's effective tax rate.
- Obtained a methodology to be used in other projects.

Biographies of alliantgroup's Project

Dhawal R. Jadhav, Managing Director - D&D Tax Credit Services Group, Dhawal has over 15 years of experience in providing R&D studies for numerous Fortune 500 clients as well.

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Pricing

- We provide our clients with a flexible success-based fee structure designed to maximize our client's cash flow and match timing of their expense to the realized benefit.
- Under this unique approach, clients can easily assess value of an engagement knowing the precise quantified benefits. Fees under this program are based on the credits we identify.
- Includes audit defense and refund provisions
- **Thus, if there are no credits, there are no fees to pay.**

Closing Comments

- R&D Brochure
- Questions?