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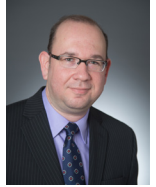
You Can Have Your Cake and Eat It Too: The Research and Development Tax Credit for the Food and Beverage Industry



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Abstract

Food and beverage innovation is a key driver in helping companies in the industry deliver on strategic goals by getting the right products to market with speed and establishing significant competitive differentiation. Successful food and beverage innovation is essential in helping companies achieve sustainable growth and profitability for the long run. We have found that the vast majority of food and beverage executives believe that product innovation or portfolio adjustments to 'healthier' trends will be the key drivers they turn to for revenue growth over the next three years. While executives acknowledge that achievement of strategic goals will be largely dependent on product innovation, many companies struggle with effectively delivering on innovation initiatives to meet those goals. Failure rates of new food and beverage products is extremely high. Several challenges that we have heard expressed by food and beverage manufacturers over the past few years include: 1) constant changes in consumer demands and volatile economic conditions, there exists a 2) highly competitive environment with an abundance of product choices, making it exceedingly difficult to create significant competitive differentiation, 3) intense price competition through pressure from competitors and private-label brands, 4) fluctuating commodity prices of crops and raw materials, and 5) developing strategy and product development initiatives to meet increasing regulatory change. For many food and beverage manufacturers, a large portion of current revenue comes from products that have been introduced into the product portfolio within the last few years. Therefore, catalyzing successful innovation is critical to the long-term strategy and success of the organization. Increasingly, companies are recognizing the importance of taking advantage of tax credits and incentives available to the Food and Beverage industry as a critical weapon in remaining competitive and harnessing innovation.

The purpose of this white paper is to help Food and Beverage industry executives and decision makers obtain a better understanding of the Research and Development Tax Credit and its applicability to their particular industry. The information covered in this article is based on our knowledge, experience, and expertise. The content is aimed at taxpayers who may be involved in qualified research activities and want to minimize their tax liability. In this paper we discuss the definition, history, and recent developments of the R&D tax credit. Then, we discuss examples of product and process improvements that qualify within the F&B industry that satisfy IRS guidelines for R&D tax credits.

I. Food and Beverage Research and Development: Why is it important ?

One common theme to success in the Food and Beverage (F&B) industry is the need to continuously innovate. Keeping products fresh is not easy in a business where product margins are slim and competitors can quickly knock off new ideas. But for those who get it right, the rewards are sweet. Our experience is that companies and brands that consistently innovate thrive, compared with those that are either non-innovators or pay it little attention. Winning food companies use broad platforms to quickly customize products for narrow segments. Those platforms may be brand platforms, go-to-market platforms, packaging platforms or technology platforms. Furthermore, identifying and acting on trends early is extremely critical. Lastly, recognizing when a trend has lost steam and making a swift exit is just as critical.



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Research and Development is a critical competitive factor for survival of food developers and fast food purveyors. These companies are constantly working to create new or improved products and improve the taste, safety, and nutritional content of their product. Accomplishing these objectives is technically challenging and expensive. Food and beverage companies constantly face rising costs of food inputs and fuel and regulatory changes while trying to keep their pricing competitive and gain market share. Some of these rising costs stem from research and development (R&D) strategies to develop new products related to food safety, cost reduction, organic/natural products, dietary guidelines, and sustainable resources.

Food manufacturers can address the cost and risk of research and development by leveraging available federal, state and local tax incentives. The failure of small businesses to take advantage of the Research & Development (R&D) tax credit is a huge area of opportunity for taxpayers. We believe that this happens because there is self-censoring. Business owners and their tax advisors have a fundamental misunderstanding of what is required to qualify for the R&D tax credit. The R&D tax credit incentivizes an enormous range of activities, including many that most food and beverage companies engage in. Furthermore, small business owners feel that these credits only apply to large corporations, when in fact they can have a huge impact on their companies.

Food and beverage companies should look closely at this incentive even if, in the past, they did not believe their activities in developing new products or processes qualified as technological research. Often, credits mistakenly are assumed to apply only to the creation of a new product or package, but food companies can qualify for research tax credits in a number of ways—including for activities they already perform.

II. Introduction: What is the Research & Development Tax Credit?

The federal Research and Development (“R&D”) tax credit, also known as the Research and Experimentation (“R&E”) tax credit, was first introduced by Congress in 1981. The purpose of the credit is to reward U.S. companies for increasing spending on research and development within the United States. The R&D tax credit is available to businesses that uncover new, improved, or technologically advanced products, processes, principles, methodologies, or materials. In addition to “revolutionary” activities, in some cases, the credit may be available if the company has performed “evolutionary” activities such as investing time, money, and resources toward improving its products and processes. Correctly calculating the R&D tax credit is critical because the credit can be used to lower the effective tax rate a company pays and to generate increased cash flow.

The R&D credit continues to be underutilized by qualified companies and their business management teams, particularly within the Food and Beverage Industry. Reasons include a misunderstanding of qualification and documentation requirements for federal and state credits, fear of triggering an IRS audit in the current or prior year tax returns, and the perception of the credits as being limited in scope or fleeting in nature due to their persistent short renewal periods.

III. How Does the Research & Development Tax Credit Work ?

The R&D tax credit is available to taxpayers who incur incremental expenses for qualified research activities (“QRAs”) conducted within the United States.

The credit is comprised primarily of the following qualified research expenses (QREs):

1. Internal wages paid to employees for qualified services;
2. Supplies used and consumed in the R&D process; and,
3. Contract research expenses (when someone other than an employee of the taxpayer performs a QRA on behalf of the taxpayer, regardless of the success of the research).
4. Basic research payments made to qualified educational institutions and various scientific research organizations.

For an activity to qualify for the research credit, the taxpayer must show that it meets the following four tests:

1. The activity must rely on a hard science, such as engineering, computer science, biological science, or physical science;
2. The activities must relate to the development of new or improved functionality, performance, reliability, or quality features of a structure or component of a structure, including product or process designs that a firm develops for its clients;
3. Technological uncertainty must exist at the outset of the activities. Uncertainty exists if the information available at the outset of the project does not establish the capability or methodology for developing or improving the business component, or the appropriate design of the business component; and,
4. A process of experimentation (e.g. an iterative testing process) must be conducted to eliminate the technological uncertainty. This includes assessing a design through modeling or computational analysis and experimenting with a material’s durability or longevity or shelf life of a food product or ingredient.

Once it is established that the activities qualify, a thorough analysis must be performed to determine that the taxpayer has assumed the financial risk associated with, and will have substantial rights to, the products and/or processes that are developed through the work completed. The next step is to develop a methodology for identifying, quantifying, and documenting project costs that may be eligible for the R&D credit. Costs that qualify for the credit include wages of employees involved in developing new or improved products or processes, supplies used or consumed during the research process, and 65% of fees paid to outside contractors who provide qualifying R&D services on behalf of the taxpayer.

Determining the true cost of R&D is often difficult because few companies have a project accounting system that captures many of the costs for support provided by the various personnel who collaborate on R&D. The typical project tracking system would not include contractor fees, direct support costs, and salaries of high-level personnel who participate in the research effort.

Appropriate documentation may require changes to the company's recordkeeping processes because the burden of proof regarding all R&D expenses claimed is on the taxpayer. The company must maintain documentation to illustrate nexus between qualifying research expenses and qualifying research activities. Furthermore, a careful analysis should take place to evaluate whether expenses associated with eligible activities performed in the company outside of the R&D department may have been missed and can be included in the R&D tax credit calculation. This is accomplished by interviewing personnel directly involved in R&D or those who are in support or supervision of R&D efforts.

IV. Recent Developments

The federal R&D tax credit has been evolving ever since it was originally enacted in 1981 and enjoys broad bipartisan political support. Most recently, the American Taxpayer Relief Act of 2012 ("The Act"), which was signed into law by President Obama on January 2, 2013, retroactively reinstated for the two year period beginning Jan 1, 2012 through December 31, 2013. In fact, the credit is more likely to be made permanent than it is to go by the wayside. This most recent extension provided companies of all sizes yet another opportunity to either take advantage of the credit or face competition that already has or will. Qualified companies doing a cost-benefit analysis should consider that most states also offer their own R&D tax credits which require similar documentation to the federal credit, thereby significantly increasing the benefits side of the equation.

The Act also included two significant modifications. First, the Act modified the treatment of acquisitions and or dispositions. Under the Act, a taxpayer acquiring a trade or business prorates the target's QREs, gross receipts, and related base-period impact based on the number of days from the time of acquisition through the end of the controlled group's tax year. The Act provides for similar treatment in the event of the disposition of a trade or business. Second, the Act modified the method by which the R&D credit is allocated to the members of a controlled group of corporations (any two or more corporations connected through a common stock ownership percentage of at least 80%). Prior to the Act, there were two different allocation methods based on the ratio of the stand-alone credit to the group credit, and the ratio of stand-alone qualified research expenses ("QRE") to group QRE. The proper method to use depended on the amount of the group credit as compared to the sum of the stand-alone credits. Under the Act, regardless of the amount of the group credit as compared to the sum of the stand-alone credits, the R&D credit allocable to the members of a controlled group is the proportionate basis to its share of the aggregate of the QRE.

Additionally, in September 2013, the Treasury Department and IRS proposed taxpayer-friendly regulations that would amend the Internal Revenue Code Section 174 definition of "research and experimentation" (also known as R&D) expenditures. Under the guidance provided in Section 174, taxpayers are allowed to either currently deduct R&D expenditures as they are paid or incurred, or treat them as deferred expenses amortizable over a period not less than 60 months. The existing regulations provide that a determination of whether costs qualify as R&D expenditures depends on whether the costs are required R&D expenses critical to activities intended to discover information that would eliminate uncertainty. The IRS is now proposing that if expenditures do qualify as R&D expenditures during the course of the development effort, it will no longer matter if the resulting product is ultimately sold or is used in the Taxpayer's trade or business.

In another positive development, the IRS announced in August 2012 that it would no longer use the "tiered issue process" to determine exam priorities and address corporate tax issues, freeing the R&D tax credit from its historical designation as a Tier I audit issue. This designation has long discouraged companies from utilizing the credit for fear of increased audit scrutiny. Now the level of compliance risk should be less of a concern for qualified companies wanting to pursue R&D tax credits.

Government officials, knowing that innovation is critical to any company's success and to overall U.S. economic growth, have legislated alternative calculation options over the years to encourage U.S. companies to invest in research and development and to make the credit more valuable and obtainable. The Alternative Simplified Credit is the most recent example, removing complications inherent in prior calculation methods and easing the documentation burden of the R&D tax credit significantly.

Legislators have also expanded the definition of what qualifies as R&D to include “process improvements” making the credit available to many previously excluded industries such as energy exploration, software development, financial services and yes, even to the food and beverage industry.

V. The Food and Beverage Industry Examples of Qualifying R&D Activities

Qualifying R&D activities as they apply to the food and beverage industry generally fall within four general buckets (see Figure 1 below): 1) new product development, 2) incremental product development, 3) new process development, and 4) incremental process development.

4 Types of Qualifying Activity: New to Company

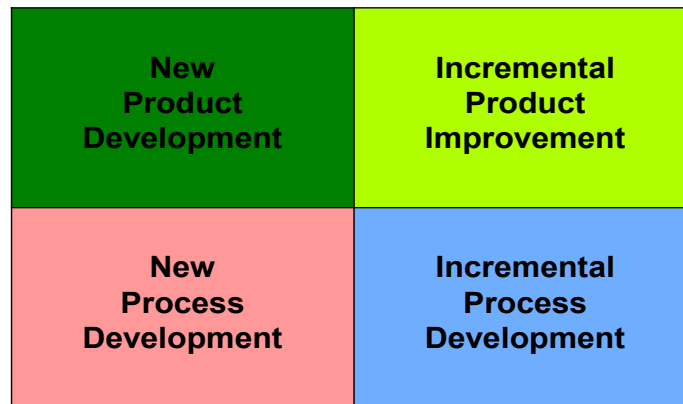


Figure 1: Four types of R&D tax credit Qualifying Research Activities, Holtzman, Yair - 2014

Specific activities that are examples of qualifying research activities include: developing new flavors, appearances, textures, health benefits, and extending shelf life. So for example, new or improved product development could include the following initiatives that may qualify as research: Improving the taste, texture, or nutritional content of food product formulations; Incorporating new or sustainable ingredients in a formula; or producing sample batches in a test kitchen or a pilot run. Other examples of initiatives include designing and developing new or improved products, such as low carbohydrate or trans-fat-free products. In some circumstances, obtaining gluten free or nut-free, allergen free, kosher/halal certification could also potentially qualify.

In addition, new manufacturing process development or improvements to the manufacturing process to enhance efficiencies as well as reduce the risk of spoilage and contamination may also qualify for the R&D tax credit.

Examples will include:

1. Improving manufacturing technology, processes, and procedures to increase yield, reduce waste and byproducts, improve safety, or comply with EPA or FDA requirements;
2. Developing new packaging and packaging systems or redesigning existing packaging;
3. Manufacturing experimental batches and pilot runs for the R&D department;
4. Developing new tools and unique kitchen equipment could also qualify;
5. Developing techniques that will reduce costs and/or improve product consistency;
6. Redesigning machinery and equipment to ensure safe handling of food;
7. Creating new packaging to improve shelf life, durability, and/or product integrity;
8. Reducing materials or using more environmentally friendly materials in packaging;
9. Introducing new chemicals or alternative materials to improve packaging;
10. Creating new methods for minimizing contamination, scrap, waste, and spoilage; and
11. Increasing energy efficiency of water, fuel, and utilities through introduction of new technologies.

Correctly calculating the R&D tax credit is critical because the credit can be used to lower the effective tax rate a company pays and to generate increased cash flow.

VI. Calculating the R&D Tax Credit

There are two standard methods of calculating the Section 41, Research and Development tax credit. The credit is reported on Form 6765 and is included with the tax return. The methods for calculating the credit: a traditional “regular credit” and the alternative simplified credit (ASC) (Sec. 41(c)(5)). Under the traditional method, the credit is 20% of the current-year qualified research expenses in excess of a base amount. One of the factors used in the calculation of the base amount is historical qualified research expenses. Using the traditional method, some taxpayers are required to determine their qualified research expenses for years as far back as 1984.

The ASC credit is 14% of the current-year qualified research expenses in excess of 50% of the average qualified research expenses for the three tax years preceding the tax year for which the credit is being determined. Companies that have not claimed the research credit in the past or that may have difficulty determining their historical qualified research expenses may find the ASC to be more beneficial.

Alternative Simplified Credit (ASC):

$ASC = (QRE(\text{current year under study}) - \text{Average of Previous 3 Years QRE} \times 50\%) \times 14\%$

Regular (Traditional) Credit Method:

$20\% (\text{Current QRE} - \text{Base Period Amount}) + 20\% (\text{Current payments to Univ.} - \text{Base Period Amt.}) = \text{R\&D Credit}$

If the special election is made under IRC 280C(c) (3) the amount of the allowable credit is determined as follows:

Reduced Credit:

$\text{Allowable Research Credit} = (\text{QRE} - \text{Base Period Amt.}) \times 13\%$

Base Period Amount:

$\text{Base Period Amount} = \text{Fixed Base Percentage} \times \text{Average of the Prior Four Years Gross Receipts}$

Conclusion

The R&D tax credit is an important competitive factor for food manufacturers as it can lower the effective tax rate and refuel their R&D efforts through increased cash flow. Food processors and developers are constantly working on creating new products, better quality, and better taste, texture, and safety of foods and beverages. Federal tax credits provide permanent benefits to drive down effective tax rates, generate cash flow, and reduce the cost of research and development. While claiming the credit requires time, resources, and expertise, it can provide significant monetary and operational benefits to businesses. Even companies currently operating at a loss may benefit because federal R&D credits generated but not used can be carried back one year and forward up to 20 years creating an opportunity when the company becomes profitable. And, if the company is acquired, the credits can be considered a valuable future asset in negotiating a selling price for the business. When credits are claimed correctly, companies can reap benefits such as increased cash flow, optimization of engineering investments, and a dollar-for-dollar reduction in tax liability.

The R&D credit is available to taxpayers who incur expenses related to new product development or significant product enhancement and new process development or significant process enhancement. Employees’ time conducting qualified research activities (QRAs) in the development process and additional development related expenses must be identified, quantified and substantiated in order to file a comprehensive, defensible claim. Four types of qualified research expenses (QREs) are the catalysts of the credit:

1. Wages paid to employees for qualified activities in the development process
2. Supplies used in the R&D process (for new product or process testing and development);
3. Contract research expenses (when someone other than an employee performs QRAs on behalf of the taxpayer to advance the product or process development, regardless of the success of the research).
4. Basic research payments made to qualified educational institutions and various scientific research organizations.

The R&D credit continues to be underutilized by qualified companies and their business management teams, particularly within the food and beverage industry. Reasons include a misunderstanding of qualification and documentation requirements for federal and state credits, fear of triggering an IRS audit in the current or prior year tax returns, and the perception of the credits as being limited in scope or fleeting in nature due to their persistent short renewal periods. Detailed time and project tracking helps facilitate nexus considerations. Documentation is usually abundant as projects are closely tracked and monitored from start to finish. Records are generally kept contemporaneously. These are key ingredients for a successful R&D tax credit claim. After all, the final value of an R&D tax credit rests with its sustainability upon IRS examination (See Figure 2 below).

Optimizing the R&D Tax Credit

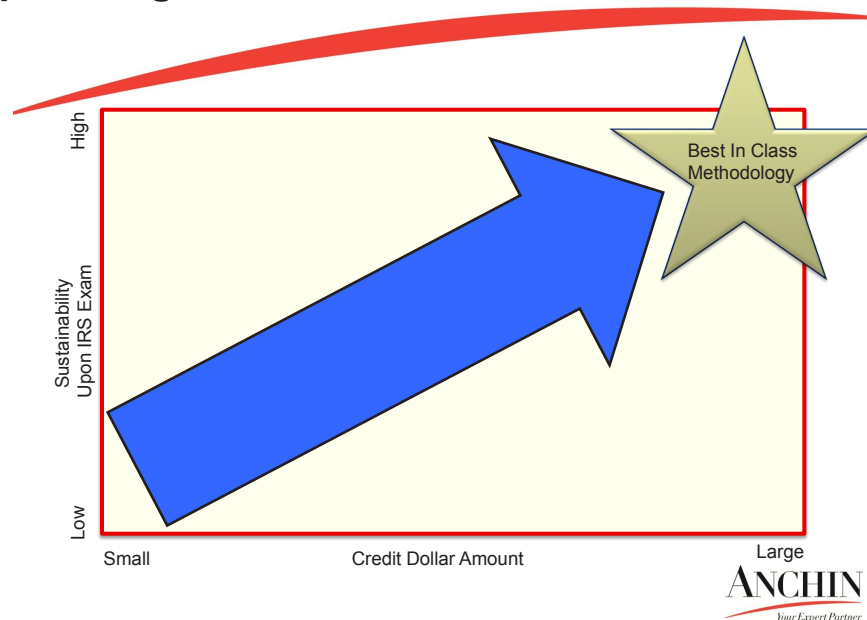


Figure 2: Optimizing the R&D Tax Credit, Holtzman, Yair - 2014

The R&D credit can be a powerful incentive, often providing a hidden source of cash from prior years' expenses while also serving to significantly reduce current and future years' federal and state tax liabilities, serve as a source of increased cash flow and a tool for refueling a company's R&D efforts. Planning ahead by creating an infrastructure that identifies qualifying research activities and collects contemporaneous documentation is essential to reducing future tax liabilities and building your R&D tax credit on a more solid foundation.

It is worthwhile for companies in the food and beverage industry to take a close look at their internal processes and think about whether they might benefit from this tax credit.

About the Author

Yair Holtzman, CPA, is a partner at Anchin, Block & Anchin LLP where he is also a member of the Firm's Tax Credits & Incentives Group as well as practice leader of the Research & Development (R&D) Tax Credits Group, Life Sciences Industry Group and Chemicals and Energy Industry Group. He has more than 20 years of experience with national public accounting and management consulting firms focusing on federal tax consulting issues and assisting senior executives with strategy development and implementation.

As a result of his in-depth experience and expertise in the R&D area, Yair has helped clients obtain several hundred million dollars in tax credits and incentives. Yair has designed and implemented procedures and technologies for companies to identify and document their R&D costs and activities in the most efficient and effective manner. He has provided sophisticated tax consulting in the areas of Section 41 R&D tax credits planning, section 199 domestic production activities deductions, M&A acquisition cost analysis, and FAS 109 and FIN 48 analysis and compliance.

Yair's expertise in the R&D area crosses a wide variety of industries, with special emphasis in Chemicals, Life Sciences, and Technology Services. He has helped companies enhance the efficiency and effectiveness of their R&D capabilities. In addition, he has helped clients improve operational performance, driving tangible results to the bottom line, by assisting them in the area of process and product development.

A frequent author and speaker on the topics of R&D tax credits, business strategy, strategic new product development, and operations excellence, Yair has been published in trade and technical journals and has spoken in academic and industry settings in the United States, Europe and Asia. He is a CPA in NY, NJ, IL and NH, a member of the AICPA, the NY and NJ State Societies of Public Accountants, and a Chartered Global Management Accountant (CGMA). He is also a member of The American Chemical Society.

Yair obtained his Bachelor's Degree with High Honors in Chemistry from Brandeis University, a Master's Degree in Accounting and Taxation with High Distinction from Hofstra University, a Master's Degree in Business Administration from the Johnson Graduate School of Management at Cornell University with a focus on Operations Management and Manufacturing, and has completed Graduate Studies in Chemistry at the University of Pennsylvania.

About Anchin

Founded in 1923 in New York, Anchin, Block & Anchin LLP is recognized as a top-tier firm nationwide in terms of its quality, management, scope of services and work environment. With a staff of approximately 350 and highly specialized industry and service teams, Anchin provides privately-held businesses and high net worth individuals with a wide range of traditional and non-traditional advisory services. Services include accounting and auditing; tax planning and compliance services; tax credits and incentives; management and succession advisory services; litigation support, forensic accounting and valuation services; and, merger and acquisition services.

Our size and culture allows us to provide this full range of services while offering personalized attention to the diverse needs of our clients. By offering superior service and a quality work product, Anchin has enjoyed long-term relationships with our clients – some for over 50 years. Our industry expertise and our commitment to client service have also earned Anchin a stellar reputation in the business, financial and legal communities.

Anchin has been consistently named one of the "best of the best" accounting firms in the nation (*Inside Public Accounting*), best accounting firms in the nation to work for (*Accounting Today*), best accounting firm in North America (*Hedgeweek Magazine*), one of the top largest accounting firms in the United States (*Inside Public Accounting*), best place to work in New York State (*Society for Human Resource Management*) and best place to work in New York City (*Crain's New York Business*).

Our mission is to be our client's Expert Partner, accomplishing this through objectivity, innovation and care. We are committed to connecting clients with partners who provide them with industry knowledge and innovative insights. Let us connect you with **Your Expert Partner** in Food and Beverage services.

About the Anchin Food and Beverage Industry Group

Anchin provides a comprehensive range of accounting, auditing, tax and advisory services designed specifically to meet the unique needs of the food and beverage industry. Our group comprises audit, tax and advisory professionals with years of experience identifying issues and solving problems for hundreds of different food and beverage companies.

Our professionals understand your industry. You will see immediate benefit from our practical approach to identifying opportunities for financial and tax savings. We look forward to offering a fresh look at your business and working with you to implement new strategies. We are credited with having guided many renowned food and beverage organizations to a superior level of financial success.

Our reputation for service has allowed us to separate ourselves from other service providers. We have grown primarily as a result of recommendations from our clients and those who have worked with us in the food and beverage industry.



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