



R&D credits for industrial manufacturers

Now more than ever



The Tax Cuts and Jobs Act of 2017 (tax reform) impacts the industrial manufacturing industry in many ways. Changes to income tax rates, net operating loss use, alternative minimum tax, interaction with base erosion and antiabuse tax, along with many positive regulatory changes the past several years, all potentially increase the value of R&D credits for the industry.

Tax reform highlights

The lower tax rate increases the value of the federal R&D credit by 14% due to the interplay with IRC section 280C. Net operating losses (NOLs) generated in 2018 and forward can only offset 80% of taxable income, and the R&D credit may be used to lower the tax on the remaining income. With the alternative minimum tax (AMT) gone for corporations and impacting fewer individual owners of flow-through businesses, the R&D credit will be available more often than before. The R&D credit can help reduce the impact of base erosion and antiabuse tax (BEAT) when a regular tax is owed. In addition, there are many planning opportunities related to R&D expenditures including the interplay with interest limitations as well as FDII and Global Low-Taxed Intangible Income (GILTI) computations and foreign tax credits. R&D expense and creditable items are found throughout the industrial manufacturing industry as discussed below. Now it is a better time than ever to evaluate R&D given its increased value and the investments being made in the Industry.

Prototypes and pilot models

In addressing the need to develop new products with new materials and capabilities, industrial manufacturers incur continual R&D expenditure to keep competitive in today's changing landscape. Oftentimes, these developments necessitate construction of full-scale, physical prototypes or trial runs to resolve underlying technical uncertainties of the product or process development. These expenditures may be eligible for the R&D tax credit regardless of the ultimate disposition of the prototype or pilot model. Yes, the pilot model can ultimately be sold or used in manufacturing, yet the underlying costs may still qualify for the R&D tax credit.

Manufacturing processes

Further, the cost of developing new manufacturing processes or improving existing ones often qualifies for the R&D tax credit. Examples include lean manufacturing activities such as evaluating the effect of process improvement on quality of products; reducing costs and environmental impacts; and improving throughput, safety, and waste stream disposal. Technology is embedded everywhere to help manage quality and cost.

Enterprise and manufacturing resource planning

Investments in enterprise resource planning (ERP) systems (including manufacturing resource planning (MRP) subsets) like **SAP, Oracle, Microsoft Dynamics**, and **Workday** are often perceived as out-of-the box solutions providing flexibility for easy deployment. However, ERP implementations are often complex and rarely synonymous with simple and routine. New definitions within the tax regulations provide opportunities to revisit ERP and other software development projects to identify activities and expenditures that may qualify for the R&D tax credit. We are finding many companies failing to look in these areas for qualified research expenditures (QREs).



Turn the page to gain a deeper understanding of the new regulations surrounding software, product, and process development and how it can impact your R&D tax credits.

How is the Internet of Things affecting industrial manufacturers?

“Everyone is now a technology company.”

Momentum around the inter-networking of physical devices, also known as the **Internet of Things**, is sparking advancement across the manufacturing industry and strengthening the potential of connected products and processes. As a result, the **industrial manufacturing** sector continues to make, on a variety of levels, significant and diverse investments that can qualify for R&D tax credits.



Product and process development

Prototypes and pilot models

A large part of the additional R&D expense opportunities made possible by the new section 174 regulations include prototypes and pilot models.

For manufacturers, the term “pilot model” can apply to any representation, including “fully functional” models, created specifically to help resolve uncertainties in product or manufacturing process design, development, or capability, even if commercial production has started. Under the section 174 regulations, the cost of these pilot models, in their entirety, may be considered R&D expenses.

The regulations also clarify that it is irrelevant whether a product resulting from qualifying R&D expenses is ultimately sold, scrapped, or used in the taxpayer’s trade or business (such as tooling used in manufacturing). The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174.

The key factor for qualifying expenses as R&D is the presence of engineering-based uncertainty. The commencement of commercial production does not automatically disqualify costs from being QREs if uncertainty remains in the product or manufacturing process design, development, or capability.

Tooling

The development of tooling, either in-house or with a strategic partner, often requires an engineering-based process of experimentation to overcome uncertainties related to the functional design, performance, and reliability, thus qualifying as R&D expense. Issues such as the tooling’s ability to meet dimensional requirements or achieve specific surface quality characteristics are common areas where technical uncertainty is resolved through a systematic process of experimentation.

Tooling revisions arising from the component’s inability to achieve dimensional characteristics, meet its specifications, combined within a system of connected parts, or combined within the confines of a defined manufacturing process is an additional area that tooling related expenditures may qualify for the R&D tax credit.



Internally developed software

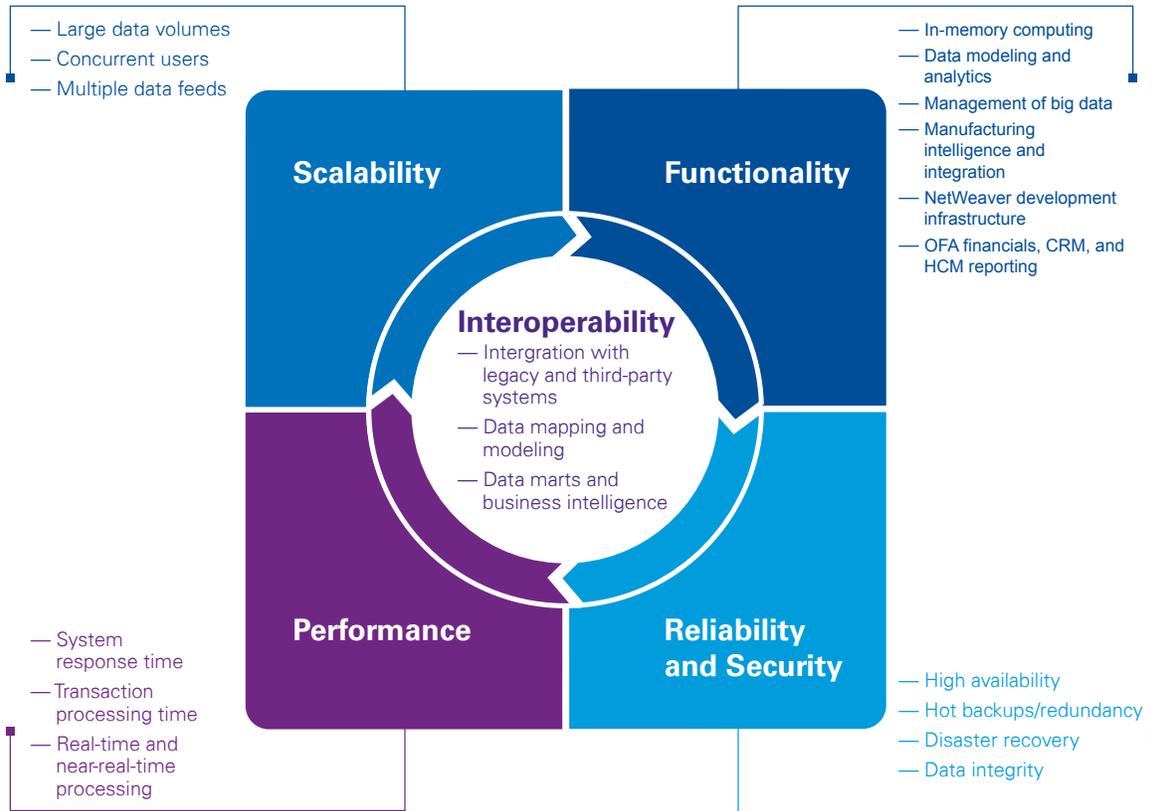
Newly issued, final regulations

Final Internal-Use Software (IUS) regulations issued on October 4, 2016 provide taxpayers with the opportunity to revisit their ERP projects and identify U.S.-based activities that may qualify for the credit. Even if an entire software project does not qualify for the R&D tax credit, the final regulations confirm that specific subsets may qualify.

Adding value to these federal incentives, state R&D tax credits are often available. While foreign research does not qualify for the U.S. tax credit, many countries provide similar credits and incentives for R&D activities occurring within their respective jurisdictions.

What elements of ERP projects qualify as R&D?

From the integration of disparate systems to the creation of proprietary functionalities and interfaces, industrial manufacturers use ERP and MRP systems to process massive amounts of data and develop new or improved functionalities that lead to increases in efficiency and advancement. As a result of their complex nature, ERP projects (including subsets such as manufacturing, supply chain, finance, human capital, customer relationship management, purchasing, etc.) often involve a wide range of activities that qualify for the R&D tax credit.



Contact us

Developments within the industry and in tax legislation present industrial manufacturers with a unique opportunity to claim incremental R&D tax credits. Call Ed Jankun, Mike Brossmer, or talk to your local Accounting Methods and Credit Services representative.

Edward Jankun
 Managing Director
T: 704-371-8090
E: ejankun@kpmg.com

Michael Brossmer
 Partner
T: 408-367-4127
E: mbrossmer@kpmg.com

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

The following information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

kpmg.com/socialmedia



© 2019 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name and logo are registered trademarks or trademarks of KPMG International. NDPPS 627123