



Do Process Improvements Still Qualify for the R&D Tax Credit?

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– TJ Sponsel
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McGuire Sponsel would like to spotlight the inclusion of raw materials in a company's R&D tax credit calculation. The opportunity to include such expenses is determined by the ability to separate what is deemed “for experimentation purposes” versus those costs that were incurred during commercial production. It is important for us to clarify this point when looking at *Union Carbide Corporation & Subsidiaries v. Commissioner of Internal Revenue* in the 2nd Circuit U.S. Court of Appeals.

The R&D tax credit provides a non-refundable credit for the cost that a taxpayer incurs when conducting research that the company would not otherwise incur. In this specific court case *Union Carbide*, a wholly owned subsidiary of *Dow Chemical*, made several process improvements. However, the caveat is that they ended up selling the finished goods; therefore, the cost of supplies could not be included.

“Affording a credit for the costs of supplies that the taxpayer would have incurred regardless of any qualified research it was conducting simply creates an unintended windfall,” said the three judge panel in its decision.

There is confusion surrounding this case and the resulting impact it has on the

R&D tax credit. The misconception is that process improvement efforts do not qualify for the credit. Process improvements are still a viable activity for the credit, but only certain materials, such as prototypes and scrapped raw materials incurred during the development phase, can be used as qualified supply costs.

The cost of material cannot be included in the R&D tax credit calculation if a company purchases material specifically for commercial production activities, uses that material for qualified process improvement activities, and then sells the resulting product. However, if that same company conducts qualified process improvement activities and the material is rendered useless, then the cost of material can be included as a qualified supply cost.

McGuire Sponsel's credit calculations are supported with reliable, conservative and contemporaneous documentation. We place importance on the qualitative aspects of a company's research and development activities. Should you have any questions related to process improvement activities and how you may potentially qualify for the R&D tax credit please feel free to contact us.