



### COVID-19 CRISIS

## A Tax Credit for COVID-19 Innovation

Manufacturers repurposing production and research to support the relief effort may qualify.

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Corporations in diverse sectors are responding to the exceptional challenges posed by the COVID-19 pandemic by optimizing their supply chains and transitioning to alternative processes to maintain essential operations in times of great uncertainty.

Manufacturers are repurposing production and research competencies to support the war on COVID-19, and are offsetting disruption by transforming idle resources to deliver relevant and advanced medical solutions and protective gear. They are doing so in response to urgent needs to help the public.

New York City, currently the national epicenter of the virus, recently sent an urgent plea for aid from “businesses with the ability to source and/or make products to support

the City’s COVID-19 response work,” including “businesses able to make new products from scratch.”

These redirected activities and efforts that serve the may potentially qualify for the Research and Development tax credit, thus maximizing companies’ liquidity and catalyzing new product development and ideation.

### **Credit for Innovation**

The R&D tax credit, first enacted by Congress in 1981, incentivizes an enormous range of activities for companies of all sizes for work done within the United States. Many activities that manufacturing companies already engage in regularly can potentially qualify.

If businesses undertake certain innovations, repurposing, optimizations, ideation, or research into alternative methods that entail overcoming uncertainty in producing COVID-19 solutions, they may benefit from this tax incentive.

But the credit continues to be underutilized by qualified companies and their business management teams primarily due to 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 requiring new-to-the world innovations.

The R&D credit is available to taxpayers for incur incremental expenses for qualified research, such as:

- Wages paid for qualified services.
- Supplies used and consumed in the R&D process.
- Contractor fees up to 65% (for qualified research activities—QRAs—on the taxpayer’s behalf, regardless

of the success of the research)d

- Basic research payments to qualified educational institutions and scientific research organizations.

To qualify for the R&D credit, the activity must meet four tests:

- The activity must rely on a hard science, such as engineering, computer science, biological science, or physical science.
- The activity 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 clients.
- Technological uncertainty must exist at the outset of the activity; i.e., 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.
- 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 engineering, mechanics, formulations, and materials.

Qualifying R&D activities as they apply to manufacturing industries generally fall into one of four general categories:

- New product development.
- Incremental product development.
- New process development.
- Incremental process development.

Examples of QRAs include developing new flavors or functional materials; improving performance; researching new health benefits; and extending shelf life. Companies shifting their current manufacturing to new products such as bacterial-resistant materials, hand sanitizer, sanitizer formulations and antibacterial developments or masks are likely to qualify.

A new or improved product development could include improving the taste or nutritional content of product designs, formulations, engineering; incorporating new or sustainable methodologies in the design; or producing samples or pilot runs.

Other examples of initiatives are designing and developing products, such as higher chemical content, more robust processes/inputs, more reliable equipment, or other enhanced technologies. Also, obtaining certifications or regulatory approval such as COVID-19 federal guideline compliance, or kosher/halal conformance can apply. 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 qualify for the R&D credit.

The R&D credit would not apply to the following:

- Routine testing or inspection activities for quality control.
- Development related to purely aesthetic properties of a product or packaging.
- Production line modifications that do not involve technical uncertainty, i.e. trouble shooting involving detecting faults in production equipment or processes.
- Market research for advertising or promotions.

- Research that is funded by a third party other than the taxpayer.
- Any other activities that do not meet the four tests discussed above.

The R&D tax credit is especially applicable to medical and biotech firms searching for a COVID-19 cure, as qualifying activities may include drug research, preclinical and discovery research for the development of new compounds, clinical R&D, quality assurance, and IT software programs to maintain and organize test or lab results.

Immunology is an extremely diverse field of medical research. Medical and pharmaceutical related R&D efforts are crucial to improving the lives of those suffering from a wide range of diseases, including COVID-19. Innovative companies investing in medical research should take advantage of R&D tax credits to increase their chances of developing a vaccine.

### **Calculating the R&D Tax Credit**

There are two standard methods of calculating the Section 41 R&D tax credit. The credit is reported on Form 6765, Credit for Increasing Research Activities, included with the tax return. The methods for calculating the credit are a traditional “regular credit” and the alternative simplified credit (ASC) .

Under the traditional method, the credit is 20% of the smaller of the current-year qualified research expenses in excess of a base amount, or 50% of the current-year qualified research expenses. 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 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.

Since the ASC only requires examination of expenses in the credit year and for the prior three years, it is a less burdensome method of computation. As such, companies that haven't 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, despite the difference in the applied percentage.

### **Worth the Investment**

While claiming the credit requires time, resources and expertise, it can also provide significant financial and operational benefits. Even companies currently operating at a loss may benefit because credits generated but not used can be carried back one year and forwarded 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.

Ultimately, the final value of an R&D tax credit rests with its sustainability upon IRS examination. Planning ahead by creating an infrastructure that identifies qualifying research activities and collects contemporaneous documentation is essential to reducing future tax liabilities and synthesizing an R&D tax credit that will be sustainable upon audit examination.

It is worthwhile for manufacturing companies to examine their internal processes and evaluate whether they might benefit from this generous tax credit, especially at a time when they need additional funds.

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