

## R&E Analysis

As we enter 2010, I wish you the best in your business and personal lives. For all of us in the accounting and tax industry, the New Year marks the beginning of our busy season. As we enter this important period of time, I wanted to provide you with a few items related to the Research and Experimentation Tax Credit.

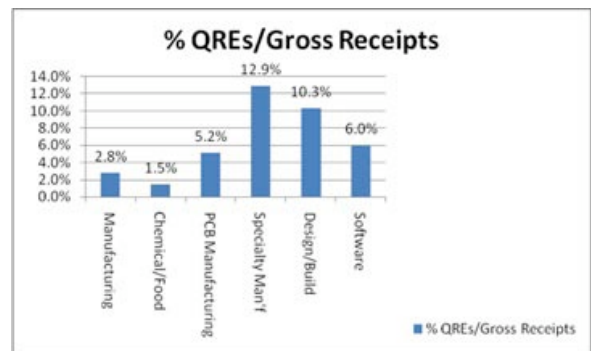
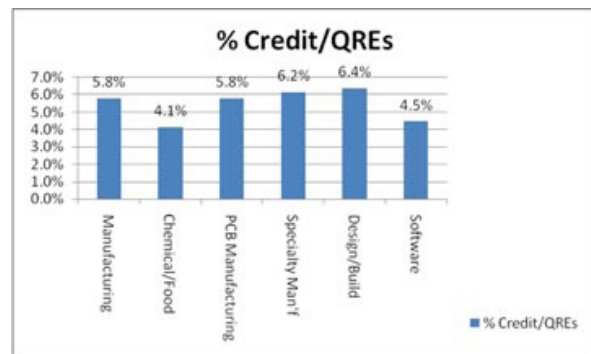
Following are two interesting charts representing two ways to measure a company's opportunity for the credit. We broke our client base down into six sectors:

- 1) Traditional Manufacturing
- 2) Specialty Manufacturing
- 3) Design / Build Companies
- 4) Electronics Manufacturing
- 5) Food Processing / Chemical Manufacturing
- 6) Software Development

Based on our experience, there are two ratios to look at when determining opportunity for the credit: 1) Qualified Research Expenditures (QREs) to Sales, and 2) Effective Federal Credit to QREs. These charts illustrate actual results from 2009.

In 2009, about 75 percent of our clients utilized the Alternative Simplified Credit. The main reason McGuire Sponsel advised our clients to move to this method was due to base period documentation issues. For some of our clients, the Standard Calculation or Start-Up Method is the preferred method due to their strong record retention policies from the base years.

I regularly see industry publications that address the R&E Tax Credit written by individuals that state they



have expertise in this area of specialty tax. I find these articles either dumb the credit down to make it appear that any manufacturer can qualify or make the credit sound so complicated and difficult to secure – from building the case to defending it before the IRS – that pursuing it is not worth the effort.

The R&E Tax Credit is not rocket science. While the qualification process leans to the engineering discipline over the accounting discipline, it is like many areas of tax legislation – perform due diligence and apply relevant case law to support a position.

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McGuire Sponsel had the opportunity to assist CPA firms and their clients in defending credits before the IRS in 2009. Some of these cases involved credits where we performed the original R&E credit claim while others involved cases where the claims were prepared by other firms, CPAs or the client.

The common areas the IRS is heavily scrutinizing are:

- Failure to provide sufficient substantiation to establish the base period;
- Failure to meet the burden of proof to support the qualified research expenditures;
- The base period has not been adjusted to reflect an acquisition of another company;
- Failure to identify specific qualified activities and related qualified expenditures; and
- The use of a blanket percentage for a specific employee group or supply cost.

Another area McGuire Sponsel has noticed that the IRS focuses on is when a company has had a previous study completed then subsequently applied those same allocations of time and supply costs on a going-forward basis. It is important that companies take a fresh look at allocations, projects and supply expenses on an annual basis.

To address this, McGuire Sponsel performs a Technical Review for about 60 percent of our clients. Technical Reviews typically entail onsite fieldwork and preparation of a condensed report that outlines a clients' activities for the current year. They are often

much more efficient, in terms of time and expense, due to the familiarity we have with the client. These engagements typically follow a larger, multi-year study performed by McGuire Sponsel in a previous year.

We have begun performing Technical Reviews for clients that had another provider perform an R&E Study. This entails a detailed review of the original report and an understanding between us and the client that changes to qualification and quantification methodologies may need to be made to comply with McGuire Sponsel's interpretation of the tax code and case law.

As always, our goal is not to provide a pile of data for you to qualify a potential opportunity. We want to be a proactive resource that provides relevant information for you to be able to serve your company or client. We at McGuire Sponsel don't desire any of our information to substitute a phone call or e-mail. We are here to serve you, our client.

As you are in the midst of addressing the annual tax position of your company or client, please let us know how we can help you. We are delighted to work with so many quality companies and professionals. We at McGuire Sponsel look forward to participating in your continued success in 2010.

Warmest regards,

TJ Sponsel II  
Director