

# Perspective

First Quarter 2008

Practical ideas for manufacturers and distributors

## Research credits - are you claiming them?

Whether you have a separate research and development department, chances are your company regularly engages in research & development (R&D) activities. Creating efficiencies, enhancing product lines and introducing new goods are done to increase revenues, improve margin and combat competitive pricing pressures. To promote business innovation, federal and some state tax laws provide a tax credit against income tax liability for R&D expenditures. Many companies can claim this credit — including yours. If you claim a domestic manufacturers deduction, your company has attributes similar to those that apply for R&D credits.

In 2007, the alternative simplified credit (ASC) went into effect and companies that were unable to claim credits under previous methodologies now potentially benefit from this new approach. In addition, other companies that claimed credits using old tactics may find ASC even more beneficial.

### R&D deduction vs. R&D credit

The R&D deduction (IRC § 174) treats relevant costs as expenses and reduces taxable income (and, in many instances, simplifies recordkeeping), while the R&D credit (IRC § 41) reduces tax liability dollar for dollar. In certain circumstances, you can take advantage of both the deduction and the credit. This opportunity can be significantly enhanced by filing refund claims for all open tax years to generate cash. Taxpayers can amend returns up to three years after the original filing.

### Don't overlook this opportunity

The main advantages of the R&D tax credit include:

- Maximizing earnings per share/profitability and cash flow
- Lowering the effective tax rate
- Capturing credits that provide insights into the true costs of products

You may benefit from the R&D tax credit if your company engages in one or more of the following activities:

- Developing new or improved products
- Developing new or improved manufacturing processes
- Increasing automation, design and fabrication of tools and dies
- Developing production equipment
- Developing new or improved software applications

The IRS recently broadened the potential of R&D tax credit opportunities by recognizing many changes in operations and product lines that are evolutionary — rather than revolutionary — which can qualify for the credit.

### Current environment

Traditional methods of quantifying costs associated with qualifying R&D activities have come under increased IRS scrutiny. The bar has been raised on documentation necessary to meet the “more likely than not” level of assurance necessary for Financial Accounting Standards Board Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*, Circular 230 and IRC § 6694 preparer penalty compliance.

Previously, your tax advisor would sign your company's tax return if they believed there was a realistic possibility (one in three chances) that each position taken on the tax return would withstand examination by the taxing authority. That benchmark has changed. Now, when your advisor signs your return, the required level of assurance is more likely than not (more than 50 percent) or the position must be disclosed in the tax return. Otherwise the IRS can assess penalties on the taxpayer and possibly the preparer. Keep in mind that the level of assurance is different for the taxpayer versus the preparer. This change only emphasizes the need for strong communication between you and your tax advisor, especially in regard to the best strategies for enhancing your company's overall tax position.

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## VAT refund changes reflect evolving Chinese market

In order to slow the growth of the People's Republic of China's (China) excessive trade surplus and to address concerns associated with goods that involve high natural resource consumption and high pollution, the nation has made significant changes to their export value added tax (VAT) refund rates. This marks the third time since 2005 that China has made changes to the rates, with this reduction affecting 37 percent of tariff codes.

The VAT was originally seen as a tool to encourage exporting from China and to keep prices low. Many other countries utilize a VAT system, but multiple factors have contributed to a positive trade surplus in China for several years. The size of that surplus, totaling over \$262 billion in 2007, has been an issue with the China's trade partners, encouraging the nation to reduce VAT refunds.

### VAT changes

Effective July 1, 2007, China reduced, or abolished, in several instances, the refund on 2,831 tariff code items. Changes were separated into three categories:

- Refunds that were cancelled
- Refunds that were significantly reduced
- Export items that are now fully exempt from the VAT

The first category consists of 553 tariff codes, most involving scarce natural resources or manufacturing activities generating high pollution or energy consumption. No VAT refund will be allowed for these products, which previously yielded a return of between 5 percent to 17 percent.

The majority of the items affected, 2,268, fall into the second category, where the VAT refund rate has been further reduced from 13 percent to 5 percent for a net reduction of 8 percent.

The final category includes 10 codes that have now been fully exempted from the VAT. However, the corresponding input VAT on these products still has to be charged and is not refunded.

High technology, biomedical or encouraged industries weren't as affected by the cuts. These changes will increase costs for many companies exporting from China. The question is what options are available to offset those costs, other than passing them on to your customers?

### How can manufacturers offset added costs?

From a tax perspective, affected companies can consider three immediate strategies:

- Review the efficiency of your existing transfer pricing policy
- Review your tariff code classification to see if a higher VAT refund rate reclassification may be possible
- Investigate whether establishing a Hong Kong trading company or a foreign invested commercial enterprise would reduce the overall VAT burden

The next step is to find a way for your company to neutralize possible additional costs. Some companies may be able to take on the extra costs. But since the profit margin in many instances is small, any excess charges could have considerable consequences. Passing the costs onto the consumer is generally an unattractive option, as sales may suffer.

Mastering lean manufacturing is one of the best ways for manufacturers to reduce costs. U.S. plants that have implemented at least one lean approaches report a median 35 percent gross profit margin and \$197,000 sales per employee, versus just 31 percent gross profit and \$150,000 for those not implementing lean. Lean is an approach that small companies can afford, requiring them only to understand the processes, identify wastes, address the root causes of problems, and then improve the process with available resources.

Look at location. While China was once among the lowest cost locations for production, other countries now may be more attractive. Also, consider where your production facilities are located relative to your markets. Producing closer to your customers can reduce costs.

Consumer and business markets are exploding in China. If your focus has been primarily on exports, this is the time focus on selling in China. The country is shifting from being strictly an export market to keeping more goods at home and improving the quality of life for their citizens. Not only will you gain sales revenue, there are no export costs for local sales.

From both production and market perspectives, China will continue to be a dominant force. But conditions in China are changing rapidly. Companies that adapt and seize on the opportunities these changes present will gain substantial competitive advantage.

**Tax tips**

**What impact will the Mexican Tax Reform Act have on your company?**

The Mexican government enacted sweeping tax changes in the Tax Reform Act, which went into effect Jan. 1, 2008. This reform created a new tax called the “flat rate business tax” (*impuesto empresarial a tasa unica*) or “IETU.”

If your company does business in Mexico, be aware that this legislation could affect your organization. For example, the IETU:

- Operates much like an “alternative minimum tax”
- Affects all business taxpayers, corporate and noncorporate, including individuals with business activities on their worldwide income and foreign residents with a permanent establishment in Mexico
- Generally affects all business revenue including independent personal services and the rental of property
- Allows limited deductions (excluding compensation) to compute the tax base, although a direct tax credit is allowed for most of the compensation expense
- Is calculated as an alternative tax and the greater of the IETU or the regular income tax becomes the liability
- Has a statutory rate of 16.5 percent for 2008, 17 percent for 2009 and 17.5 percent for 2010 and thereafter
- Permits companies, operating under the IMMEX program (known as *maquiladoras*), a tax incentive in the form of a tax credit that will reduce their IETU liability

*Note: The assets tax was repealed on Jan. 1, 2008.*

Strongly consider meeting with your advisor to discuss your company’s specific situation and the tax implications of the IETU influencing your Mexican operations.

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**R&D credit approach**

Companies should consider taking the following approach to develop and sustain credits:

- Project qualification
  - Identify R&D projects and initiate project numbers early
  - Establish and retain project files outlining the development process
  - Track start and commercial production dates
- Wages
  - Link employees and activities to respective projects
- Supplies
  - Tie costs to projects
- Contract research
  - Develop a vendor list to track services performed and address rights and risk issues

The rules in this area modify regularly, so keeping abreast of revisions can be an ongoing challenge. That’s why your tax advisor must maintain contact with the U.S. Department of Treasury, the IRS, Congress, the National Association of Manufacturers and the U.S. Government Accountability Office.

These ever changing rules provide opportunities as well. By embracing the IRS adjustments, your company can get a better look at costs, understand how many people are actually involved in projects and realize the true cost of manufacturing and development.

The current R&D tax credit expired on Dec. 31, 2007, before federal legislation was approved to extend the credit. Congress has historically renewed the credit and has done so several times throughout the last 20 years (the current Congress has indicated they intend to as well). It’s crucial legislators hear from manufacturing companies about the role and significance of this tax credit and how it helps keep U.S. manufacturers competitive through innovation.

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