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Annual R&D Credit Update

February 7, 2024



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Session CPE Requirements

- You need to attend 50 minutes to receive the full 1 CPE credit.
- 4 Attendance Markers that read: “I’m Here,” will be launched during this session. You must respond to a minimum of 3 to receive the full 1 CPE credit.

****Both requirements must be met to receive CPE credit****



Learning Objectives

At the end of this session, you will be able to:

- Recognize what activities and expenses qualify under the R&D credit rules
- Describe how the credit can be applied against income and payroll taxes
- Discuss how recent judicial, regulatory and legislative developments impact the credit
- Recognize the impact of Section 174 capitalization requirement



Agenda

- Overview of R&D Tax Credit Rules
- Procedural Update – IRS Proposed Changes to Form 6765
- Legal Update
- IRC Section 174 Update
 - Overview & Recent IRS Guidance
 - Legislative Update
 - Proposed Legislation





R&D Tax Credit

Overview



Qualified Research Activities: Four-Part Test

Permitted Purpose

- Activities must relate to Function, Performance, Reliability, or Quality of a Business Component
- A Business Component can be a product, process, technique, formula or software that is being developed for sale, lease or license to customers, or for use in your trade or business

Technological in Nature

- Activities must rely on principles of hard science, such as:
 - Biological Sciences
 - Physical Sciences
 - Engineering
 - Computer science/Software Engineering

Elimination of Technical Uncertainty

- Activities must be intended to eliminate technical uncertainty relating to capability, methodology, or best design of the Business Component

Process of Experimentation

- Activities must constitute elements of a process of experimentation, which may involve:
 - Developing one or more hypotheses/alternatives
 - Testing and analyzing the hypotheses/alternatives
 - Refining or discarding the hypotheses/alternatives



Additional R&D Requirements

Economic Risk

- Party claiming R&D must bear economic risk of loss for the costs associated
- Consider contract terms (fixed price vs time & materials)
- Is the taxpayer required to pay whether or not the research / development is successful?

Rights

- Taxpayer must retain substantial rights to the intellectual property that is developed.

In the USA

- Activities must take place in the United States in order to qualify for credit.
- Activities that take place in foreign countries are not eligible for federal R&D credit.



Specifically Excluded Activities

Research after commercial production or release

Research in the social sciences, arts, or humanities

Research relating to cosmetics, taste or seasonal design factors

Adaptation of existing business components to a particular customer's requirements

Duplication of existing business components

Surveys (e.g., efficiency surveys, management surveys, marketing research, routine data collection, routine QC testing)



Quantifying Qualified Research Expenses

Wages - Employees performing, supervising or supporting qualified research

- Percentages of time multiplied by federally taxable wages paid
- Actual hours is best if available

Materials and Supplies - Supplies used in carrying out qualified research (can include prototypes)

- Includes direct materials and supplies used in the prototyping or first article phases
- Supplies such as cutting tools can qualify if used in qualifying research

Contract Research Expenses – Contractors engaged to perform qualified research

- Must be structured so the taxpayer bears the economic risk

Leased computing costs (e.g., cloud computing costs)



Credit Benefit



Typically between 7% and 10% of qualified costs



Directly offsets tax liability



Startup Companies may be eligible for payroll credit

Starting in 2023 up to \$500K

Offsets employer portion of Social Security and Medicare taxes





Procedural Update

IRS Proposed Changes to the 2024 Form 6765



Form 6765 Proposed Changes



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Current form does not require information regarding Qualified Research Activities

Beginning with Tax Year 2024, IRS proposed Form 6765 will include fields with detailed information



Form 6765 Proposed Changes

- New Section E

Section E—Other Information (See instructions)

45	Enter the number of business components generating the credit computed on line 15 or line 32	45	
46	Enter the amount of officers' wages included in line 5 or line 24	46	
47	Did you acquire or dispose of any major portion of a trade or business in the tax year? Yes <input type="checkbox"/> No <input type="checkbox"/>		
48	Did you identify any new categories of expenditures included in the current year QRE? Yes <input type="checkbox"/> No <input type="checkbox"/>		
49	Did you determine any of the QREs on line 9 or line 28 following the ASC 730 Directive? Yes <input type="checkbox"/> No <input type="checkbox"/> If "Yes," enter the amount from Appendix C, Line 19	49	
	This ASC 730 Directive only applies to taxpayers with assets equal to or greater than \$10,000,000 who follow U.S. GAAP to prepare their Certified Audited Financial Statements showing the amount of currently expensed Financial Statement R&D. See instructions.		

Form **6765** (Rev. 12-XXXX)



Form 6765 Proposed Changes

Section F: Business Component Info

- Descriptive Name
- Information sought (Technical Uncertainty)
- Alternatives evaluated (Process of Experimentation)
- New or Improved (Permitted Purpose)
- Business Component Type & Use
- Amount of wages by project
- Direct supervision wages by project
- Direct support wages by project
- Cost of supplies by project
- Contract research by project

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Form 6765 (Rev. 12-2000)

Section F—Business Component Information. Information for each Business Component (BC) (see instructions). Complete Lines 50 through 57 for each business component. If you have more than ten business components, see instructions.

BC	50(a) EIN of the controlled group member conducting the research activities on this business	50(b) Controlled group member's principal business activity code	50(c) Business component's descriptive name	50(d) Describe the information sought to be discovered and identify the one or more alternatives evaluated in the process of experimentation for each business component. Use the space provided.
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				

BC	50(e) Is the business component new or improved (select one)	50(f) Business component type (select one from available options)	50(g) Business component use (select one from available options)	50(h) Software (if applicable, select one from available options)
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				

BC	51 Direct research wages for qualified services	52 Direct supervision wages for qualified services	53 Direct support wages for qualified services	54 Total qualified wages (Add line 51, line 52, and line 53)
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				

Form 6765 (Rev. 12-2000)



Reporting & Form 6765 Updates

- **Suggested actions for taxpayers in 2023**

- Start building R&D project lists for each R&D cost center and provide high level details on description, technical challenges, and process of experimentation.
- Start to track time to actual R&D projects. This will help produce labor by project that is proposed by the IRS.
 - Time Tracking (if available)
 - Time Surveys
 - Interviews





Legal Update

Recent Court Cases and State Legislation



Recent Cases

- *Little Sandy Coal, Inc. v. Commissioner* 62 F.4th 287 (7th Cir. 2023)
 - The 7th Circuit **agreed** with the Tax Court’s decision that the taxpayer did not provide substantial documentation that the activities performed by both the production and non-production employees were experimental in nature.
 - The 7th Circuit **disagreed** with the Tax Court’s decision to exclude direct support, direct supervision, and direct research including production employees' activities from the POE “substantially all” test.
 - The Appeals Court provided a formula for determining whether a taxpayer has met the “substantially all” test:

Research activities that constitute elements of a POE

*Research activities not excluded under section 41(d)(4) and
whose expenses are deductible under section 174*



Recent Cases



- ***Little Sandy Coal, Inc. v. Commissioner* 62 F.4th 287 (7th Cir. 2023)**
 - The lesson for taxpayers is to adequately document that substantially all such activities were research activities that constitute elements of a process of experimentation.
 - "Generalized descriptions of uncertainty, assertions of novelty, and arbitrary estimates of time performing experimentation are not enough."
 - "Other taxpayers seeking to avail themselves of the research tax credit would be well-advised to document research activities for subcomponents (Shrink Back) if they cannot demonstrate a process of experimentation at the business component."



Recent Cases

- **Moore v. Commissioner, T.C. Memo 2023-20**
 - The court disallowed the labor and time of taxpayer's Chief Operating Officer in computing the research credit.
 - In the course of discussing the research projects, it was revealed that the taxpayer was engaged in qualified research and that the COO had also been involved in research activities. Additionally, the COO was listed as a product patent holder for a particular project.
 - Although the COO played a significant role in the development of new products, there was no evidence in the record to indicate which part of the COO's work on new product development satisfied the criteria for "qualified research."
 - Lack of documentation led to the exclusion of COO's wages as QRE's, a common trend in recent court cases.



Recent Cases

- **Betz v. Commissioner, T.C. Memo 2023-84**
 - Taxpayer claimed research credit on custom air pollution control system for manufacturing plants. Tax court determined projects did not involve sufficient uncertainty for related costs and wages.
 - Tax court found the IRS properly disallowed costs because taxpayer failed to show the functional products custom-built for customers were "**Pilot Models**" or adequately substantiate the connection between wages and qualifying research (Nexus).
 - "Merely identifying a project's difficulty and the eventual design solution, without bridging the gap with evidence as to what investigative activities were performed, does not satisfy petitioners' burden."
 - Funded Research – In contract review it showed the taxpayer gave "all substantial rights" of work product to customer. "Retained only incidental benefits from the project."
 - Taxpayer was assessed Section 6662 accuracy-related penalties.



Recent Cases

- **Key take aways from recent court cases**

- Adequately document that substantially all the activities on a project are experimental in nature.
- Generalized descriptions of uncertainties or assertions of novelty are not enough to defend a qualifying project. Be specific!
- Document subcomponent (Shrink Back) if you cannot demonstrate a process of experimentation at the business component level.
- Track time, supply costs, and contractor expenses to specific projects.
- Secure internal documentation or records of who worked on projects and what work they were performing on the project.
- Supply costs on pilot models & prototypes must be incurred to eliminate technical uncertainty.
- Documentation on all potentially qualifying projects may be requested in an audit. A statistical sample does not guarantee that only the sample will be reviewed.



State R&D Credit Updates

Missouri

- New credit available on or after January 1, 2023, and MO will provide \$10m annual pool of R&D credits which can be used against MO Corporate Income Tax and Financial Institutions Tax.
- Must apply for credit using an application process.
- Credit may be transferred, sold, or assigned to another taxpayer.

Kansas

- Kansas R&D credit is increasing from 6.5% to 10% on qualified expenditures for tax year beginning January 1, 2023.
- For tax years beginning 2023 and thereafter, the credit is transferrable by a taxpayer without a current tax liability.



State R&D Credit Updates

Texas

- State still trying to implement regulatory changes enacted in 2021.
- Certain activities/industries completely excluded from credit eligibility (designs cannot be business components)
- Software claims are being highly scrutinized, especially internal use software
- State auditors being trained on new rules
- Exams are dragging out with the State

Arizona

- As of January 1, 2023, ASC is available
- This is a refundable credit for those with under 150 employees worldwide
- State allocates \$5M total / \$100K per eligible taxpayer
- Application process is first come first served on 1st business day of year at 8am





Section 174 Update

Specified Research & Experimentation Capitalization
Requirement & Pending Legislation



Research & Experimentation Capitalization



- Tax years beginning after 12/31/2021
- Capitalize Specified Research & Experimental (SRE) Expenses
- Domestic SREs amortized over 5 years
- Foreign SREs amortized over 15 years



Section 174 Legislative Update

H.R. 7024 – Tax Relief for American Families and Workers Act of 2024

- House passed bill on January 31, 2024
- Senate up next
 - Recess February 12 – February 23
 - May markup and send back to House



H.R. 7024 – As Currently Written

- Delays domestic SRE capitalization until years beginning after December 31, 2025.
- Foreign SRE will still be subject to 15-year amortization
- Retroactive to 2022
 - May elect to recoup 2022 unamortized SREs: 50% in 2023 & 50% in 2024.
 - Procedures unclear
 - Statement?
 - Form 3115?



Section 174 Timeline



Accounting Method Change

- 1st Tax Year beginning after December 31, 2021, attach statement
- If no statement attached in 1st Tax Year, Form 3115 **REQUIRED**



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Notice 2023-63 (Sept. 8, 2023)

SRE = R&D costs in the experimental or laboratory sense

All costs incident to development or improvement of a product	Costs of obtaining a patent	Labor costs	Materials and supplies costs	Cost recovery allowances (depreciation, amortization, etc)	Overhead costs (rent, utilities, insurance, taxes, repairs and maintenance, security and similar)	Travel costs for performance or support of SRE activities
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Allocation method – on basis of cause-and-effect relationship



Research Performed Under Contract (Notice 2023-63)



If research provider bears financial risk and has rights **CAPITALIZE**



If research provider does not bear financial risk, but has a right to use any resulting SRE product (without seeking approval) in its business or through sale, lease or license **CAPITALIZE**



Notice 2024-12 Exception: If research provider obtains SRE product right that is

Separately bargained for or

Was acquired for the limited purpose of performing SRE activities under the contract



IRS plans to address double capitalization issue in Spring 2024 per IRS associate chief counsel



Disposition, Retirement or Abandonment of SRE



Sale of SRE or its usefulness does not equal ability to write off these costs



Unless company ceases to exist under a non-Section 381(a) transaction, amortization must continue



Unamortized SREs do not give rise to basis for gain/loss purposes in dispositions

Long-term Contracts Under Section 460

Example

	Pre-2022	Notice 2023-63 Guidance
Total Revenue Under Contract	1,000,000	1,000,000
Total Expected Costs	800,000	800,000
Inception to Date Non SRE Costs	100,000	100,000
ITD SRE Costs	150,000	-
ITD SRE Amortization	-	15,000
ITD Costs (Numerator)	250,000	115,000
Total Expected Costs (Denominator)	800,000	800,000
Percentage of Completion	31%	14%
ITD Revenue Recognized	312,500	143,750

Percentage of Completion

- Taxpayer may include amortization of SRE, rather than full cost of SRE in PCM calculation
- Timing difference
- Likely requires accounting method change
- Tracking costs will help maximize benefit





Questions?



Thank you!

Michael De Prima, Principal
Michael.DePrima@CLAConnect.com

Ginny Veit, Principal
Ginny.Veit@CLAConnect.com

Eric Zeitler, Manager
Eric.Zeitler@CLAConnect.com



CLAconnect.com



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