

Annual R&D Tax Credit Update

February 6, 2025



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Session CPE Requirements

- You need to attend 50 minutes to receive the full 1 CPE credit.
- There will be 4 polling questions throughout the presentation.
 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

01

Recognize what activities and expenses qualify under the R&D credit rules

02

Describe how the credit can be applied against income and payroll taxes

03

Discuss how recent judicial and legislative developments impact the credit

04

Recognize the impact of the Section 174 capitalization requirement





Speakers



Ginny Veit Principal



Aaron Willis Manager



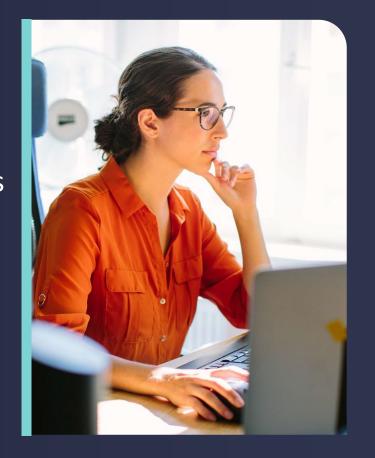
Eric Zeitler Manager





Agenda

- R&D Tax Credit Basics
- R&D Tax Credit Updates
 - Statutory and Procedural Changes
 - Recent Court Cases
 - State Credit Updates
- Sec. 174 R&E Capitalization Updates
- Sec. 174 Legislative Update







Polling Question

Today, I'm most interested in learning about:

- What qualifies as an R&D tax credit
- Recent legislative and judicial developments regarding R&D credits
- R&D credit reporting updates (Form 6765)
- State-specific R&D credit developments
- 174 landscape







R&D Tax Credit Basics



Overview

Dollar-for-dollar reduction in taxes due

Net federal benefit is typically 7% to 10% of all qualifying costs

Credit can be carried back one year or forward 20 years

Federal payroll tax offset

State credits (refundable in some states)

Documentation is critical to support the credit upon potential audit





Qualified Research: Four-Part Test

- 1. Permitted purpose
 - Activities must relate to the function, performance, reliability, or quality of a business component
 - A business component can be a product, process, technique, formula or software
- 2. Technological in nature
 - Activities must rely on principles of hard science, such as:
 - Biological, physical sciences
 - Engineering
 - Chemistry
 - Computer Science / Software engineering





Qualified Research: Four-Part Test

- 2. Elimination of technical uncertainty
 - Activities must be intended to eliminate technical uncertainty relating to capability, methodology, or best design of the business component
- 3. Process of experimentation
 - Substantially all activities must constitute elements of a process of experimentation, which may involve:
 - Developing one or more hypotheses/alternatives
 - Testing, analyzing, and refining the hypotheses/alternatives





Qualified Research Expenses (QREs)

Four expense categories are used to compute the credit:

Wages

Performing, Supporting, or Supervising
Qualified Research



Contract Research

Amounts paid to
Contractors/Consultants for
R&D (subject to 35%
reduction)



Cloud Computing Expenses such as AWS, Azure, etc.

Supplies

Materials/Supplies, Prototypes, Tooling Costs







R&D Credit Updates



Statutory Changes



Payroll tax credit increase

- Payroll tax credit increased to a max of \$500,000 as of Jan. 1, 2023 (up from \$250,000)
- Offsets employer social security and Medicare taxes

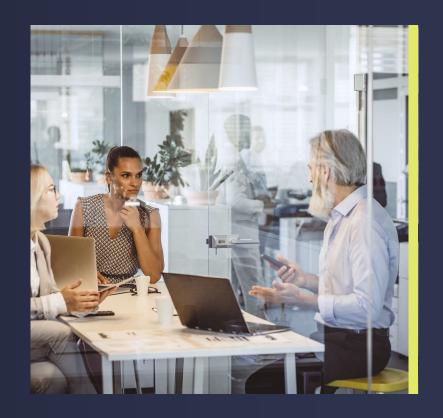




Statutory Changes

Section 280C change

- Sec. 280C changed due to Sec. 174 change
- Sec. 174 capitalized expenses reduced only if the current year credit exceeds 10% of current year QREs
- 280C election still available but generally not advised







Form 6765 Changes for 2024

Section E-Other Information. See instructions.							
37	Enter the number of business components generating the QREs on line 5 or line 20	37					
38	Enter the amount of officers' wages included on line 42	38					
39	Did you acquire or dispose of any major portion of a trade or business in the tax year? Yes No						
40	Did you include any new categories of expenses as current year QREs?						
41	Did you determine any of the QREs on line 5 or line 20 following the ASC 730						
	Directive?						
	If "Yes," enter the amount from Appendix C Line 19 (you may attach your Appendices A, B, C, and D here)	41					
	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 Changes: New Section G

Form 6765 (Rev. 12-2024)

Section G—Business Component Information. Complete lines 49(a) through 49(f) for each business component you are required to report. See instructions. Attach additional sheets if necessary to capture all business components.

		s. Attach additional sheets if necessa	,		-
ВС	49(a) EIN of the controlled group member conducting the research activities on this business component	49(b) Controlled group member's principal business activity code		49(c) siness component's name nique alphanumeric identifier (see instructions)	49(d) Business component type (select one from available options)
2		BEAS	D.		1 Dec deset
3	Contr	olled Group	Bu	siness	1. Product
4	Contin	oned Group			2 Duo 2002
5	Info (i	f applicable)	Co	mponent	2. Process
6	inio (i	f applicable)			2 All Othors
7			■ Na	mes	3. All Others
8					
9			-		
11					
12				1DA	
13					
14					
15					
ВС	(if ap	49(e) Software oplicable, select from the available options)		Describe the information sough	49(f) to be discovered. Use the space provided.
1	a.	IUS			
2	a.	103		I II ala Ia	
3	b	DFS		High le	vei
5	N				
6	C.	Excepted from	IIIS	descrip	tion
7		zacepted iroini			
8		treatment			
9 10					
11	d.	Non-IUS			
12					
13					
14					
15					

Form **6765** (Rev. 12-2024)





Form 6765 Changes

- Section G optional for all filers for tax year 2024.
- Will continue to be optional for:
 - Qualified small businesses claiming the payroll tax credit, or
 - Taxpayers
 - with total QREs of \$1.5 million or less
 - with \$50 million or less of gross receipts, and
 - claiming the credit on an originally filed return

Form 6765 (Rev. 12-2024)

Section G-Business Component Information (continued). Complete lines 50 through 56 for each business component. If you have more than fifteen business components, see instructions.

вс	50 Direct research wages for qualified services	51 Direct supervision wages for qualified services	52 Direct support wages for qualified services	53 Total qualified wages (add line 50, line 51, and line 52)	
1					
2	Direct	Supervision	Support	Total	
3	Direct	Super vision	Jupport	Total	
4	14/		10/	Magas	
5	Wages	Wages	Wages	Wages	
	0	9			
uttuommento					
Total					
ВС	Cost of supplies			56 Applicable amount of contract search expenses (see instructions for eporting basic research payments)	
1	Compelia	s Lea	cod	Contract	
2	Supplies	s Lea	seu		
3					
4	Cost	Comr	outing	Labor	
_					





Amended Returns – Refund Claims

- Refund can be claimed for up to 3 years
- Additional information required
 - Identify business components to which credit claim relates
 - Identify all research activities performed
 - Provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year





Polling Question

Does your organization use R&D tax credit?

- Yes we have filed for R&D credits in the past
- Yes we are planning on filing in the future
- No
- Not sure we could use help evaluating credits
- Not applicable











Recent Court Case - Little Sandy Coal

Substantially all / process of experimentation test

"Substantially All" Fraction (80%) =

Research Activities Constituting
Process of Experimentation
Sec 174 Research Activities Not
Excluded Under Sec. 41(d)(4)





Recent Court Case Phoenix Design Group







State Credit Updates

Arizona

• NEW: Alternative Simplified Credit

Michigan

- Enacted R&D credit effective Jan. 1, 2025
- Businesses with fewer than 250 employees claim 3% of QRE + 15% of amount exceeding base not to exceed \$2M/year
- Businesses with 250 or more employees claim 3% of QRE + 10% of amount exceeding base not to exceed \$250K/year
- Total credits can't exceed \$100M if so prorate





State Credit Updates

Missouri

- Enacted R&D credit effective Jan. 1, 2023
- Annual program cap of \$10 million, limited to \$300K per taxpayer
- First \$5 million of cap is reserved for Minority Business Enterprises, Women's Business Enterprises, and small businesses (50 or fewer FTEs)

Texas

- Challenges continue with regulatory changes
- Software is major issue





Polling Question

I'd like to talk to someone at CLA about:

- How to determine if my business is eligible for R&D tax credits
- Help with filing for R&D tax credits
- ☐ Planning with Section 174
- Other tax planning opportunities
- ☐ Nothing at this time







Section 174 Updates



Sec. 174



What is a Sec. 174 expense?



Sec. 41 is a subset of Sec. 174 expense



Awaiting proposed regulations





Notice 2023-63

- Expenses subject to capitalization as expected
- Funded research problematic
- Acquisitions/dispositions for partnerships
- Specific rules for software development

Primary guidance we're operating under currently (Sep. 8, 2023) Clarified by Notice 2024-12 (Dec. 22, 2023) Provides guidance on: Types of SREs Section 460 Funded and allocation interplay with **Dispositions** research methods

Section 174





Notice 2023-63: Examples of SRE Expenditures

Examples of SRE expenditures:



Labor costs



Materials and supplies



Cost recovery



Operation and management costs







Notice 2023-63

Funded Research

- Research provider vs. research recipient
- Rules governed by Treas. Reg. Sec. 1.174-2(a)(10) and (b)(3)
- Departs from two-prong analysis (right and risks)
- Requested comments on similarity to Section 41(d)(4)(H)



Research Provider Funding

Under Notice 2023-63

If research provider bears financial risk and has rights CAPITALIZE

If no financial risk, but research provider has right to use resulting product CAPITALIZE

If no right to use resulting product, but research provider has risk.

CAPITALIZE

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

- Separately bargained for or
- Acquired for limited purpose of performing SRE activities under the contract

IRS plans to address double capitalization in future guidance





Dispositions under Section 174

Section 174(d)

 Requires continued amortization if SRE property is disposed, retired, or abandoned during the amortization period of such property. No immediate deduction is allowed.

Section 381(a) Transactions

 If corporation ceases to exist in a Sec. 381(a) transaction, acquiring corporation will continue to amortize the distributor or transferor corporation's unamortized SRE expenditures over the remainder of the amortization period beginning with the month of transfer.

Non-Section 381(a) Transactions

 If corporation ceases to exist and Sec. 381(a) does not apply, corporation is allowed a deduction equal to the unamortized SRE expenditures in its final taxable year.

Asset Transactions

- Seller must continue to amortize SRE expenditures even after the sale and cannot factor unamortized costs into gain/loss under Sec. 1001.
- Same result if applicable asset acquisition under Sec. 1060.





Section 460 Percentage of Completion Method

- Costs allocable to contract using PCM include only SRE amortization in numerator
- Amortization deductions treated as incurred in the taxable year the amortization is deducted







Section 460 PCM Impacts: Per Rev. Proc. 2024-09

For purposes of determining the percentage of contract completion, estimated total allocable contract costs include either:

- All amortization of SRE expenditures that directly benefit or are incurred by reason of the performance of the long-term contract
- Only that portion of such amortization expected to be incurred and deducted during the term of the contract.



Taxpayer using first alternative

Required to report any portion of the contract price not previously reported by the taxable year following the taxable year in which the contract is completed, notwithstanding that some portion of the SRE expenditures remain unamortized.





Polling Question

Did you find the information in this CLA webinar helpful to you and your organization or business?

- Yes
- No







Sec. 174 Legislative Update



Sec 174 Legislative and Procedural Updates

Tax Relief For American Families And Workers Act (HR 7024) stalled in senate

Next major milestone could be proposed regulations (Presidential EO may stall issuance)

Several pieces of guidance have come out over the last 12 months, substantive and procedural





Sec. 174 Legislative Outlook

- One big beautiful bill vs. two reconciliation bills
- Bipartisan support for reinstatement of expensing
- Possible small business carve out for domestic R&D
- Retroactive repeal unlikely
- Foreign R&D will continue to be capitalized









Q&A



Thank you!

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