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Annual R&D Tax Update

February 22, 2023

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Learning Objectives

At the end of the 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 and legislative developments impact the credit
- Recognize the impact of the Section 174 capitalization requirement



Agenda

- R&D Tax Credit Basics
- Legal Update
 - Amended Claim Procedures
 - *US v. Grigsby*
 - *JG Boswell Co. v. Commissioner*
- IRC Section 174 Update
 - Capitalization Requirement in Effect for 2022
 - Overview of Section 174 Expenses
 - Accounting Method Changes
 - Impacts to R&D Credit





R&D Tax Credit Basics

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Credit Overview

Dollar-for-dollar reduction in taxes due

Net fed 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 (up to \$250,000; moves to \$500,000 in 2023)

State credits (some are refundable)

Documentation is critical to support the credit upon potential audit



Qualified Research: Four-Part Test

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

Technological in Nature

- Activities must rely on principles of **hard science**, such as:
 - Biological, physical sciences
 - Engineering
 - Computer science/data science

Elimination of Technical Uncertainty

- Activities must be intended to **eliminate technical uncertainty** relating to **Capability, Methodology, or Best Design** of the Business Component

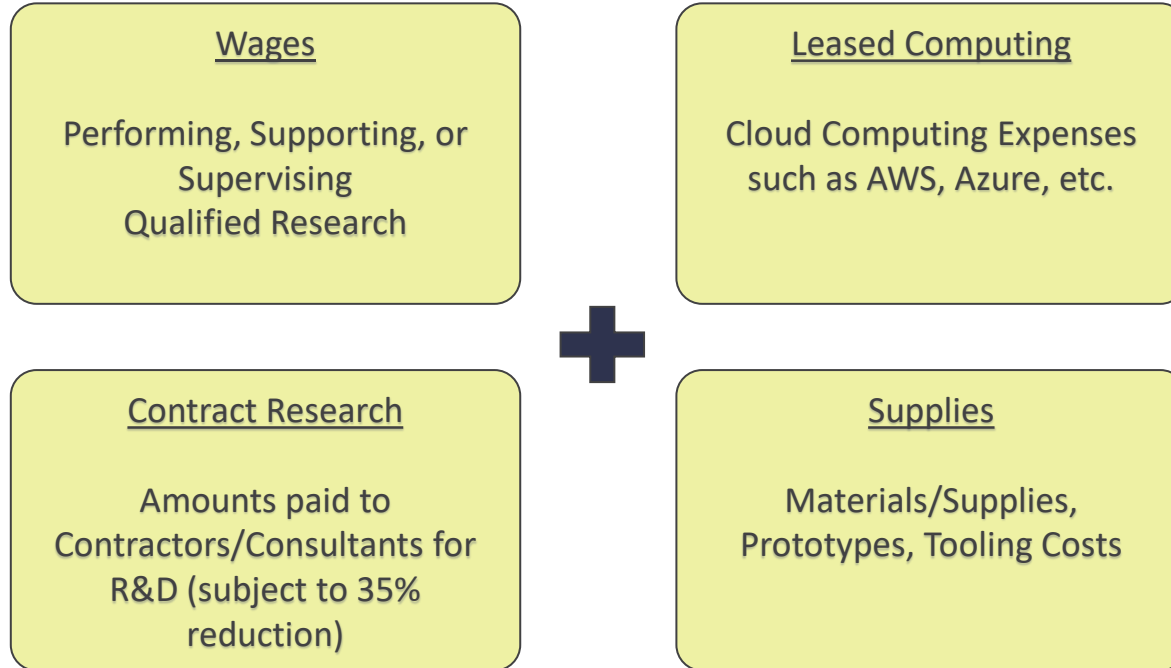
Process of Experimentation

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



Qualified Research Expenses (QREs)

- Four expense categories are used to compute the credit:





Legal Update



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Amended Credit Claim Procedures

- Effective Jan. 10, 2022
- Transition period gives taxpayers 45 days to cure deficient claims; IRS extended transition period to Jan. 10, 2024
- Form 6765 instructions updated to include new procedures
- Taxpayer must provide the following info:
 - Identify all the business components to which the research credit claim relates
 - For each business component, identify all the research activities performed
 - For each business component, name the individuals who performed each research activity (a taxpayer may instead identify the individuals who performed each research activity by listing the individual's title or position)
 - For each business component, describe the information each individual sought to discover
 - Provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses paid or incurred for the research credit claim (may be done by using Form 6765)
- If taxpayer submits a credit study, must identify exact pages containing five items above



US v. Grigsby (aka Cajun Industries)

Cajun Industries is a civil construction company in Louisiana providing services in the oil and gas, chemical processing, power and utilities, and water quality industries



Engaged a third-party provider to amend returns to claim R&D tax credits



Taxpayer and IRS agreed to use a sampling of four projects and contracts



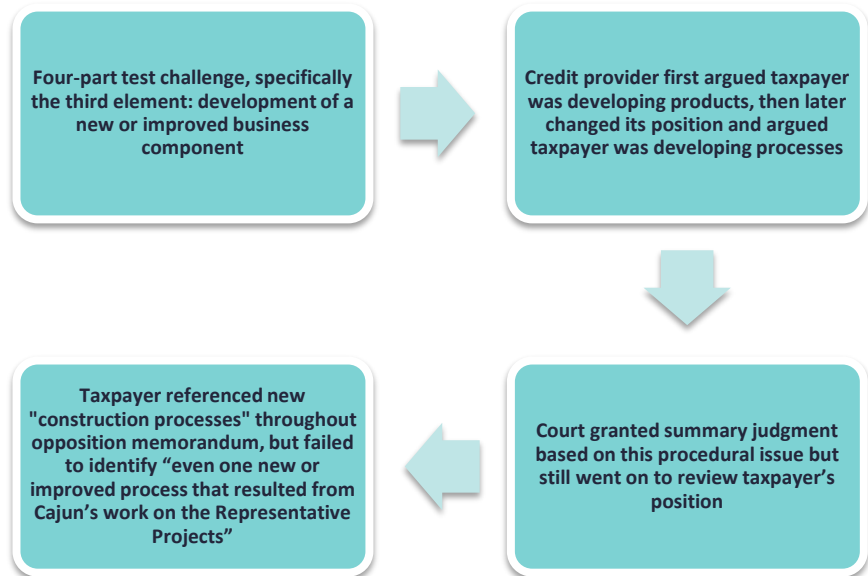
Two main issues under review in District Court

- Business component test
- Research funding



US v. Grigsby – Business Component Test

- From the Tax Court:
 - *Defendants' obfuscation deprives the Court of any meaningful criteria by which to measure whether Cajun's alleged "construction processes" were, in fact, new or improved, as required to establish the business component element*



US v. Grigsby – Research Funding

- Substantial rights at issue – must show taxpayer maintained the right to use or exploit its research without having to pay for it (*Lockheed Martin*)
- Court focused on work product and work-for-hire provisions in representative contracts
- Contract clauses reviewed:
 - *Work Product* includes all “data, analyses, reports, plans, procedures, manuals, drawings, specifications, calculations, or other technical tangible manifestations...”
 - *Technical Information* covers “all inventions, discoveries or improvements (patentable or otherwise) that are made or conceived by [Cajun] in performing the Work”



US v. Grigsby – Takeaways

- Bad facts? Bad representation? Both?
- Does this change how construction and A&E firms claim and support the credit?
- Must show new/improved processes
 - Uncertainty regarding means and methods of construction not enough
- Work-for-hire focus is problematic
 - Common provision seen in various types of contracts
 - Practitioners have commonly understood substantial rights inquiry to relate to underlying IP and know-how rather than tangible manifestations of the work
 - Does this change the substantial rights analysis?



JG Boswell Co. v. Commissioner

- Motion for summary judgment in Tax Court
- Taxpayer operates large farming business in California growing cotton, tomatoes, alfalfa hay, and safflower
- Approx. 7% of farmland was used for research and crop trials for both improved varieties and greater yields
- At issue was QREs relating to crop research trials
- Focus on distinction between process- and product-related business components
- IRS argued taxpayer's QREs should be limited to the excess of expenditures incurred on research acres over expenditures taxpayer would have incurred by cultivating the same land as production acres
- IRS's motion for summary judgement was denied



JG Boswell Co. v. Commissioner – Takeaways

- Only a ruling on the motion for summary judgment, and not a decision carrying precedential value, but...
- Order reinforces distinction between products and production processes when establishing business components; this is often overlooked by taxpayers (production processes are their own business components under Section 41)
- Signals a *potentially* favorable position for agriculture and farming operations that incur costs to increase yield and test growing techniques





Section 174 Update


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Background

Tax Cuts and Jobs Act eliminated full expensing of research and experimental (R&E) expenses under section 174 effective 1/1/22



R&E costs must now be capitalized and amortized

- 5-year amortization for domestic R&E
 - 15-year amortization for foreign R&E
 - Placed in service using a midpoint convention
- 

Congress could not come together to defer this change in a year-end tax bill despite support on both sides, therefore taxpayers need to account for this for tax year 2022

Overview of Section 174



Expansive definition of R&E under Section 174 (broader than the R&D tax credit)

The term generally includes “all such costs incident to the development or improvement of a product”



Costs that are not eligible for the R&D credit may still be Section 174 expenses (e.g., G&A, offshore research, fringe benefits)



Many questions are still unanswered (e.g., contract funding, controlled groups, short years)



Taxpayers that capitalize R&D for book purposes will still need to review additional costs potentially subject to Section 174



Common Section 174 Expenses



**Salaries and wages
(includes fringe and
payroll expense)**



**Materials, supplies,
and prototype costs**



Contractor expense



Patent and legal costs



**Overhead allocable to
R&E activities or cost
centers (e.g., utilities,
rent)**



Licenses/subscriptions

Impact on R&D Credit

- Section 174 change does not directly impact calculation of the credit under Section 41
- QREs may serve as a basis for Section 174 costs, but further analysis is required
- Credit is arguably more valuable than ever in order to ease the Section 174 addback
- Credit benefit may also be larger beginning in 2022 due to a change in the research expense disallowance under Section 280C
- Section 280C now provides:
 - If the amount of the credit determined for the taxable year, *exceeds*
 - The amount allowable as a deduction for such taxable year for qualified research expenses, then
 - The amount chargeable to capital account for the taxable year for such expenses **shall be reduced by the amount of such excess**
- In other words, the “gross” credit (rather than an election to take reduced credit) will be more beneficial for most taxpayers



Section 174 Accounting Method Change

- Rev. Proc. 2023-8 (modified by Rev. Proc. 2023-11) covers new automatic change (DCN 265)
- Made on a cutoff basis; no Section 481(a) in first year
 - If change is not made in first year, then a modified Section 481(a) adjustment is required
- For this year only, taxpayers can make the change via:
 - Form 3115, or
 - An equivalent statement
 - Statement must include:
 - ✓ A description of the type of expenditures included as R&E
 - ✓ The amount of the R&E expenditures for the year of change
- If the statement is not filed this year, then a Form 3115 must be filed in a subsequent year, with a modified Section 481(a) adjustment



Section 174 Compliance/Risk Issues

Law change must be accounted for; it's not optional



Taxpayers may be hesitant to perform analysis because they're in losses, have never claimed an R&D credit, etc.



Implications for estimated tax payments, tax provisions/UTPs, and state income tax filings



What Now?

Congress could still step in and defer the capitalization change, but it might be unlikely anytime soon with the divided Congress

Need legislation to attach “fix” to

Treasury has indicated guidance may be forthcoming, but is not priority

Taxpayers/practitioners will need to look to other areas of tax law for guidance and filing positions where Section 174 is silent or ambiguous

Extending tax returns is an option with the hope of legislative action or guidance from Treasury



Thank you!

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