Optimizing Research and Experimental Costs

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WEALTH ADVISORY | OUTSOURCING | AUDIT, TAX, AND CONSULTING

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Agenda

- Background
- Definition of R&E expenses
- Current law and treatment of R&E expenses
- TCJA changes effective January 1, 2022
- The R&E tax credit
- Planning for TCJA changes

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Background of §174

- Enacted in 1954 to allow taxpayers to deduct research and experimental (R&E) expenditures
- Prior to §174, these expenses were capitalized and oftentimes never recovered
- Deduction for R&E expenses incurred “in connection with” a trade or business
  - Compare with §162, which allows ordinary and necessary expenses “in carrying on” a trade or business
  - Section 174 allows deductions even if the T/B is not yet active
  - Must show “realistic prospect” of entering into a T/B with the results of the R&E
  - Section 195 (startup expenditures) has a carveout for R&E expenses
- Courts have been very liberal in permitting §174 treatment
- Applied on a project-by-project basis, but must be consistent within each project

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Definition of R&E expenses

- Primary definition found in Treas. Reg. §1.174-2(a)(1)
- Expenditures which represent costs in the experimental or laboratory sense
  - Includes all such costs incident to the development or improvement of a product, including the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application
  - Intended to discover information that would eliminate uncertainty concerning the development or improvement of a product
  - Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product
  - The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under §174

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Definition of R&E expenses (cont'd)

- A "product" includes "any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license"
- Treasury Decision 9680 (2014) made several changes to the §174 regulations, including:
  - Pilot model rules
    - Pilot model means any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product
    - The term includes a fully functional representation or model of the product or a component of the product
  - Ultimate success/failure language
  - Depreciable property clarification
    - Deductions for expenditures in connection with the acquisition or production of depreciable property to be used in the taxpayer's trade or business are limited to amounts expended for R&E
    - Does not include production costs after uncertainty is eliminated

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Section 174 methods (current law)

- **Full expense method under §174(a)**
  - See generally Treas. Reg. §1.174-3
  - Expense in year incurred
  - May be adopted without election/consent
  - No basis in cost
  - Applies to all expenses in current and subsequent years
- **5-year amortization under §174(b)**
  - See generally Treas. Reg. §1.174-4
  - Election must be made by the due date of the income tax return in the year in which the expenses were first incurred
    - Statement attached to tax return and signed by taxpayer or representative
  - Amortization period cannot be less than 60 months, but could be longer
  - Amortization starts in month when benefits of the R&E are first realized
- **Capitalization**
  - If neither expense method is used, costs must be capitalized and depreciated/amortized

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Section 59(e) election

- Election to amortize §174 costs over 10 years
- Why would you choose this method?
  - Non-corporate taxpayers subject to AMT and R&E that is not material to the business
  - Removes adjustment for AMT
- Taxpayers may utilize this method even if not using it for AMT adjustment purposes
- Election appears to be eliminated under TCJA changes effective Jan. 1, 2022

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Software under Rev. Proc. 2000-50

- What is software?
  - Any program or routine that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine
- Rev. Proc. 2000-50 essentially permits software costs to be treated as §174 expenses
- Three methods presently:
  - Current expense under §174(a)
  - Amortization under §174(b) (or a longer period)
  - Amortization over 36 months under §167(f)

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Section 174 method changes

- Section 174 changes available (Form 3115, DCN 17)
  - From capitalization to expense or amortize
  - From expense to amortize
  - From amortize to expense
- Section 174 changes are all on a cutoff basis and do not receive audit protection
- Rev. Rul. 58-74 also permits amending open tax returns to claim expenses under §174(a) that should have been included on original return (see also LAFA 20170501F)
- Software expense changes are a different method change (Form 3115, DCN 18), and are made with a §481(a) adjustment

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TCJA changes

- Changes are effective Jan 1, 2022
  - Could be overturned before it goes into effect
  - Two bills pending that would keep §174 as-is
- Current expense is no longer available
- New §174 uses the term “specified research or experimental expenditures”
- 5-year amortization required for domestic R&E
- 15-year amortization required for foreign R&E
- Software is now called out as a specified R&E expenditure subject to amortization

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The R&E tax credit (§41)

- First enacted in 1981
- In order to qualify for the credit, an expense must first be eligible under §174
- Credit is more restrictive than the R&E deduction
- Dollar-for-dollar reduction in taxes due
- Net benefit is typically 7% to 10% of all qualifying costs
- Unused credit can be carried back one year or forward 20 years
- Certain companies can offset their payroll taxes and the alternative minimum tax (AMT) with the credit
- In addition to the federal benefit, many states have R&E credits
- Documentation is critical to support the credit upon potential audit

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Changes under the PATH Act

- The Protecting Americans from Tax Hikes (PATH) Act of 2015 made 3 important changes to the credit:
  - Made the credit a permanent benefit in the tax code (previously a temporary provision)
  - Qualified small businesses can use the credit to reduce federal payroll taxes on Form 941 (more on this later)
  - Eligible small businesses can use the credit to offset AMT
    - Eligible small business is generally one with average annual gross receipts of $50 million or less for 3 preceding tax years

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Definition of qualified research (4-part test)

Requirement 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 that is being developed for sale, lease, or license to customers, or for use in your trade or business

Requirement 2: Technological in Nature

- Activities must rely on principles of hard science (e.g., biological/physical sciences, engineering, computer science)

Requirement 3: Elimination of Technical Uncertainty

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

Requirement 4: Process of Experimentation

- Substantially all of the activities (80%) must constitute elements of a process of experimentation, which may involve:
  - Developing one or more hypotheses/alternatives
  - Testing, analyzing, and refining the hypotheses/alternatives

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Excluded activities

The following activities do not qualify for the credit:

- Research after commercial production or release
- 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)
- Foreign research
- Research in the social sciences, arts, humanities
- Research funded by any grant or contract
- Research relating to cosmetics, taste, or seasonal design factors

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Qualified research expenses (QREs)

- **Wages**
  - Performing qualified research
  - Directly supervising qualified research
  - Directly supporting qualified research
  - 80% test
- **Supplies**
  - Prototypes
  - Materials and supplies
  - Tooling costs
- **Contractor payments**
  - Must analyze financial risk and retention of intellectual property rights
  - Generally reduced by 35% for every qualified dollar
- **Cloud computing costs**
  - AWS, Azure, etc.

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Calculating the credit

- The credit is an incremental benefit that rewards increases in year-over-year qualified spend
- Base amount measures increases and decreases
- Two methods to compute the federal credit: Regular Credit and Alternative Simplified Credit (ASC)
- Both look at current year QREs in excess of a base amount, but the credit percentages and base amounts differ
- Regular Method (20% credit)
  - Base amount is a function of QREs and gross receipts for a statutorily prescribed period
  - This method is generally preferable for startups
  - Can be difficult for established companies to develop their base amount
- Alternative Simplified Credit (14% credit)
  - Base amount equals 50% of average QREs for the 3 prior year tax years
  - This method is generally preferable for established companies
  - Easier to administer
- States have historically followed the regular method, but more are moving to ASC calculations
- Research expense disallowance lowers the effective rate of the credit (currently 21% reduction)

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Documenting the credit

- Documentation is critical to support qualified activities and expenses
- Must create nexus between costs and activities/projects
- IRS focuses heavily on how credit was determined and how the 4-part test applies
- Wage qualification is a substantial focus when claiming and examining a credit
  - Project tracking vs. use of estimates
- Estimates can be acceptable but are subject to greater scrutiny
- Federal credit claimed on Form 6765 filed with tax return (support does not need to be filed)
- Recent focus by IRS and Tax Court on documenting the process of experimentation
- No hard and fast rule regarding types documentation
  - Design submittals
  - Product tracking logs
  - RFPs
  - Emails

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The R&E payroll tax offset

- Early-stage companies can elect to apply their R&E credit against payroll tax
- Credit offsets the employer portion of social security tax (6.2%)
- Taxpayer must be a Qualified Small Business:
  - Less than $5 million in gross receipts for the credit year, and
  - Does not have gross receipts for more than 4 years preceding the credit year
    - Clock starts with first year of gross receipts
    - Definition of gross receipts for this purpose is very broad (includes interest)
- Payroll tax election must be made on original, timely filed return (including extensions)
- Credit is applied on Form 941 (must file a Form 8974 with the 941)
- Credit can start offsetting payroll tax beginning with the first quarter following the quarter in which the income tax return is filed
- Be sure to coordinate with payroll provider

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Planning for R&E expense changes

- Start assessing potential impacts now
- Companies with offshored development and startups will be heavily impacted
- Need to evaluate §174 vs. §162 treatment
- Book to tax differences
- Consider onshoring development work
- R&E credit may be more attractive due to the deduction timing difference
- Method changes required

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