

# R&D Tax Credits

Chattanooga Tax Practitioners

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**S+H**

# Meet the Presenter



**Brad Pittman, CPA**

Director, Specialty Tax Services

- + Nationwide specialty tax services practice leader with 16+ years of public accounting experience
- + Collaborated with domestic and international companies across a wide range of industries throughout career
- + Additional subject matter expertise in transfer pricing and foreign derived intangible income (“FDII”) topics
- + Avid golfer and college football fan

# About Smith + Howard

## Firm Background

- + A family of companies built to help our clients grow
- + A group of over 250 high caliber professionals in 26 states
- + Serve clients on both a local and national level
- + Driven by core values: **Clients, People, Excellence** and **Integrity**
- + Best Tax and Accounting Firm by *Forbes* for four years
- + Top 100 Firm and Fastest-Growing Firm by *INSIDE Public Accounting*
- + Best of the Best Firm by *INSIDE Public Accounting*



# Historical Background + Core Concepts

## Core Concepts

- + **Qualifying Research Activities** – activities that meet the so-called “four-part test” are considered as qualifying research activities (“QRAs”).
- + **Qualifying Research Expenses** – the expenses tied to the QRAs performed, generally wages paid, contract development expenses incurred and materials and supplies consumed in development are known as qualifying research expenses (“QREs”).
- + **Most Relevant Industries:**
  - + Manufacturing
  - + Software Development
  - + Construction

# Qualifying Research Activities

## The Four-Part Test

- + Must be for a permitted/qualified purpose (Business Component Test)
- + Must be technological in nature (Employ one of the hard sciences)
- + Must intend to eliminate technical uncertainty
- + Substantially all activities must exhibit a process of experimentation

# Qualifying Research Expenses

- + **Qualifying Wages** - the wages (or portion of wages) of the personnel who directly perform qualifying activities. “Substantially All” rule - > 80% of an employee’s time spent on QRAs = 100% of wages eligible for credit consideration.
- + **Qualifying Materials/Supplies** - The cost of any materials/supplies used in qualifying activities. Case law supports the claim of materials/supplies used in a saleable product in certain instances.
- + **Qualified Contract R&E Expense** - Development spend with a U.S. based third-party multiplied by 65% to reach the qualifying contract expense amount.

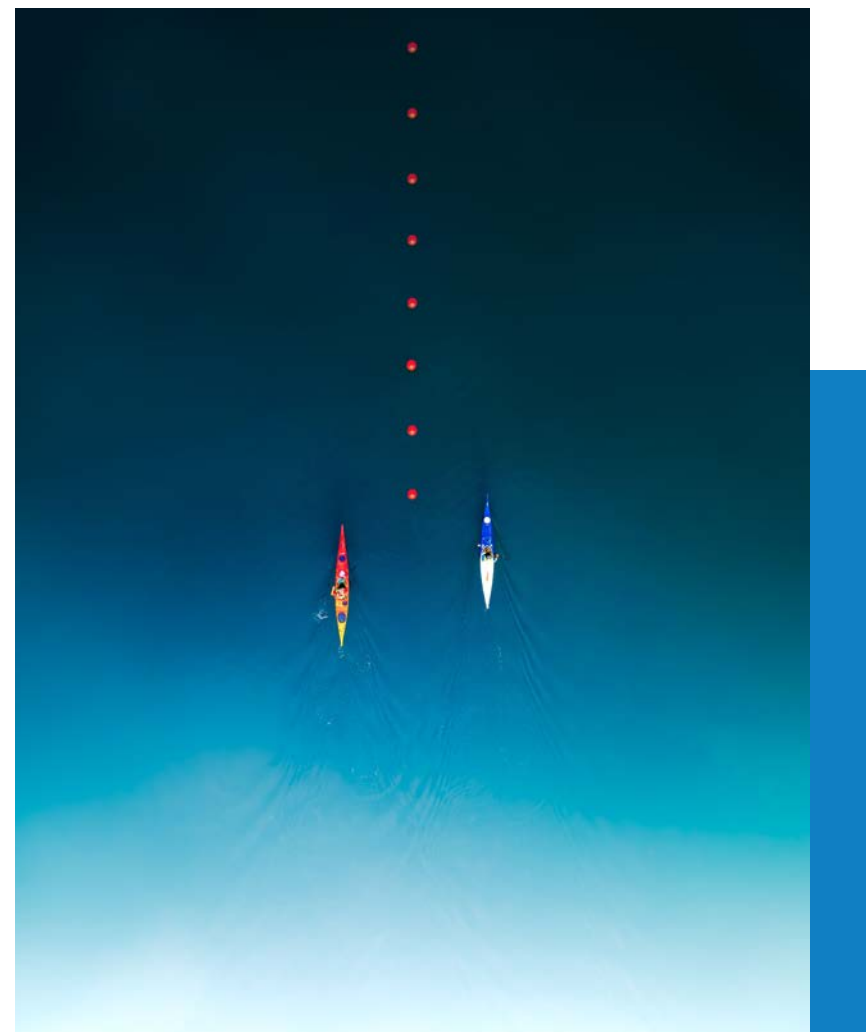


# Internal Use Software

## Higher Threshold of Innovation Tests

There are three additional tests that must be applied in the case of internal use software that are known as the heightened threshold of innovation test (“HTIT”):

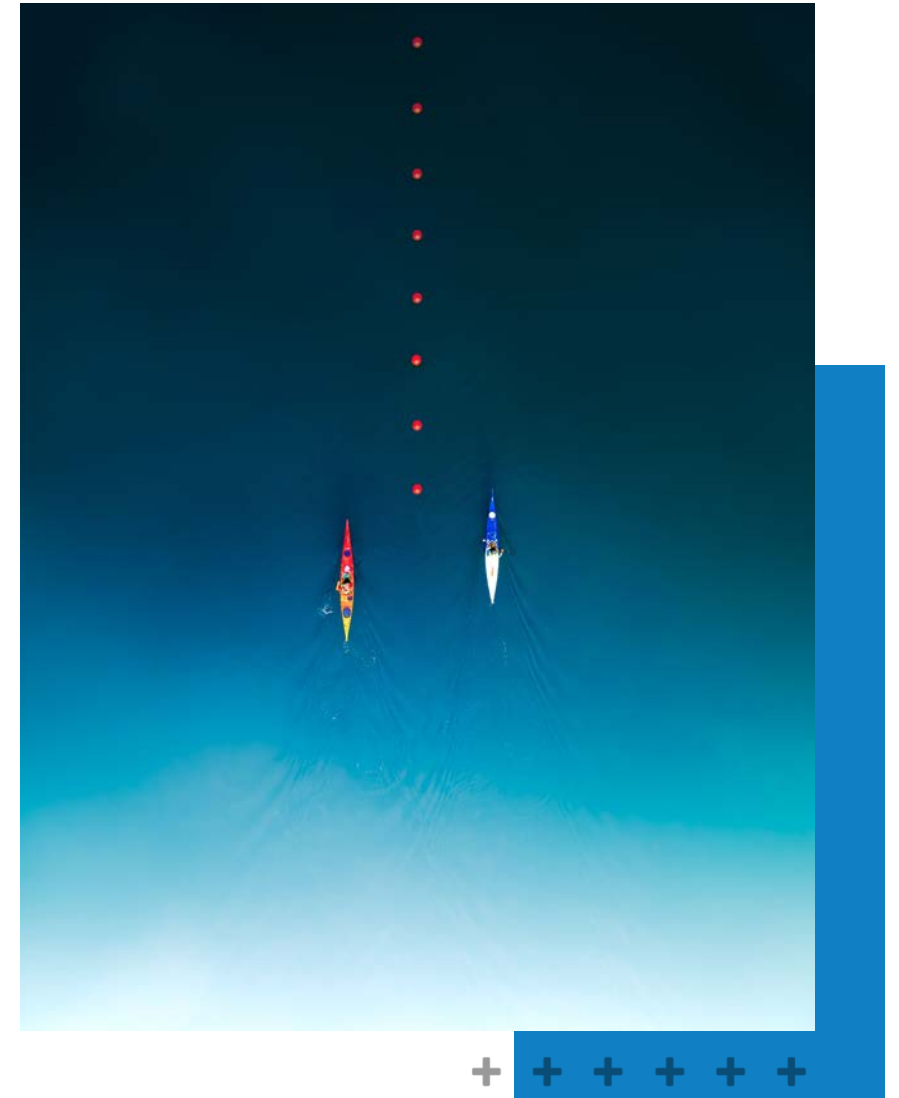
- + The software is intended to be innovative as measured by a reduction in cost, improvement in speed, or other measurable improvement that is substantial and economically significant if the development is or would have been successful
- + The software development has significant economic risk in that the taxpayer commits substantial resources to the development and there is substantial uncertainty because of technical risk as to whether the resources can be recovered within a reasonable time



# Internal Use Software

## Higher Threshold of Innovation Tests

- + The software is not commercially available, i.e., cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the innovation and significant economic risk requirements





# Internal Use Software

## Higher Threshold of Innovation Test

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# Funded Research

## Funded or Unfunded?

- + Research that otherwise meets the four-part test may still be ineligible for credit if the research is determined to be funded.
- + Research is determined to be funded if either of the following tests are not met:
  - + The taxpayer must bear the risk of failure related to any amounts paid in connection with the agreement to which the research is tied.
  - + The taxpayer must retain substantial rights in the research with substantial rights being determined as the taxpayer having the right to use or exploit the results of the research.
- + If the agreement between the taxpayer and its customer does not explicitly speak to these points, it is a facts and circumstances-based assessment that drives whether the expenses incurred in connection with the agreement can be applicable towards a credit calculation.

# R+D Credit Considerations

## Regular or Alternative Simplified Credit Method

- + Regular = 20% of qualified research expense over a defined base amount (PY QREs and Sales are factors)
- + ASC= 14% of qualified research expense for the taxable year that exceed 50% of the average qualified research expenses for the three prior years
- + Both alternatives should be considered
- + Federal credits generally carry forward 20 years after being carried back 1 year

# R+D Credit Considerations (continued)

## Gross or Net Credit (i.e., 280C Election)

- + Prior to TCJA, gross credit had to be added back in calculation of federal taxable income.
- + Remedy was to make a 280C election to reduce credit by corporate rate and avoid add back to taxable income.
- + Beginning in 2022, generally only gross credit in excess of research and experimental deductions must be added back with minor adjustments applying.
- + Advantageous for most taxpayers to defer 280C election in 2022 and later years

# R+D Credit Considerations (continued)

## Amended Credit Claims

- + Federal R+D credits can be retroactively claimed by filing Form 6765 with amended tax return(s).
- + Opportunity for immediate cash savings from previously unclaimed credits.
- + Available for all tax years open under general 3-year statute of limitations.
- + May require amending state tax returns as well depending on materiality of adjustment to federal taxable income.
- + Amended credit claim reporting requirements were revised substantially per IRS Chief Counsel Memorandum (“CCM”) 20211401F issued via October 15, 2021, press release

# R+D Credit Considerations (continued)

## Amended Credit Claims (continued)

As a result of October 2021 IRS CCM, all amended credits claims require reporting of five pieces of information along with claim effective January 2022:

- + Identify all the business components to which the Section 41 research credit claim relates for that year.
- + For each business component, identify all research activities performed.
- ~~+ Name the individuals who performed each research activity.~~
- ~~+ Describe the information each individual sought to discover.~~
- + No longer required beginning June 18<sup>th</sup>, 2024
- + Provide the total qualified employee wage expenses, total qualified supply expenses and total qualified contract research expenses for the claim year (done via filing of Form 6765).

# Alternative Applications

## Federal Credit

### Qualified Small Business Payroll Tax Credit for Increasing Research Activities

- + Election made via Form 8974
- + Must have:
  - + Less than \$5 million in gross receipts in the election.
  - + No gross receipts reported on a tax return for any taxable year before the five taxable year period ending with the taxable year of election.
- + Originally up to \$250,000 of credit could be applied against employer's share of Social Security tax.
- + Revised to \$500,000 starting in the 2023 tax year via the Inflation Reduction Act of 2022 with a portion of the credit now able to be applied to employer's portion of Medicare in addition to SS tax.
- + Great opportunity for start up companies.

# State R+D Tax Credits

## Providing a Valuable Second Layer of Credit

- + State credits can provide a valuable second layer of credit to taxpayers.
- + Currently 36 states offer some form of R+D tax credit to taxpayers involved in research and development activities.
- + Calculation methodologies vary, although a number of states employ methodologies that align with the Federal ASC method.
- + Essentially all states latch on to the federal definitions of QRA and QRE.
- + State credits generally carryforward for between five and ten years depending on the state.
- + Some states offer refundable credits or credits that can be offset against state payroll withholding (Georgia is a payroll withholding state).
- + As previously mentioned, QREs generally are only considered to the extent the activities are performed in-state and/or materials are consumed in-state.



# IRC 174 – Amortization of R+E Expenditures

## Treatment of Expenses

IRC 174 governs the treatment of expenses incurred for research and experimental (R+E) purposes.

- + Definition of R+E is similar but broader compared to definition of R+D under IRC 41 and generally includes all expenses considered as QREs under IRC Section 41 plus other expenses not available for credit including:
  - + Foreign development expense incurred
  - + Patent related costs
  - + Overhead allocations to R+E activities
  - + Depreciation expense on equipment used in research and experimental activities

# IRC 174 – Amortization of R+E Expenditures

## Treatment of Expenses (continued)

TCJA changed the treatment of these expenses beginning in the 2022 tax year:

- + Pre-2022: All expenses were fully deductible in the year incurred.
- + 2022 and after: Expenses required for tax purposes to be capitalized and amortized.
  - + Over a five-year period for domestic expenses.
  - + Over a 15-year period for foreign expenses.

Substantial loss of immediate deductions for R+E spend in 2022 and subsequent years.

**\*Legislative Update\*** - The Tax Relief for American Families and Workers Act of 2024 passed the House end of January and continues to sit with the Senate. This bill would:

Restore full expensing of R&D costs · Restore 100% bonus depreciation · Revise calculation around business interest expense limitation

# Questions? Contact me.



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**Thank you.**

**S+H**