

The Evolving Landscape of Business Tax Credits:

R&D, SECTION 174 AMORTIZATION, AND SUBSTANTIATION BEST PRACTICES

2024



Soar to New Heights with Tax Incentives
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CTI Presenter



Taylor Melton

J.D.

Director, R&D Technical Sales

Taylor brings significant experience as a Research and Development (R&D) tax credit specialist to CTI. With a Bachelor of Science from Texas A&M University, and a J.D. from South Texas College of Law Houston, he utilizes his background in business, law, and technical application to identify and secure tax incentives for various types of businesses across various industries. Throughout his career, he has performed hundreds of R&D credit projects and secured millions in tax credits for his clients.

As one of CTI's Directors, Taylor oversees and works directly with R&D Project Managers, focusing on detailed analysis, substantiation of R&D credit claims, and application of the governing tax law to the specific activities and operations of each client. Taylor also works directly with CPAs and Businesses to evaluate eligibility, assess compliance, and determine available benefit.

Taylor can be reached directly at (832) 306-6144 or tmelton@ctillc.com

Agenda

- Develop a deeper understanding of the R&D tax credit and how the credits are relevant to various industries
- Understand latest changes to the Federal and State R&D tax credits
- Discuss best practices for substantiating and documenting your R&D claim
- Discuss key IRS areas of focus pertaining to the R&D credit
- Section 174 Expense capitalization and amortization

Who We Are



**Founded
in 2001**



**Nationwide
Services**



**Over 180
Seasoned
Experts**



**Over \$50 Billion
Credits Secured**

INCENTIVES FOCUS AREAS



WOTC/
Employment



Research &
Development



Cost
Segregation



179D / 45L
Energy Incentives

OUR KEYS TO SUCCESS



Planning &
Goal Setting



Proprietary
Technology Solutions



Dedicated
Customer Service



Communication &
Reporting

Incentives Type & Timing

Automatic (No approval required)

- Work Opportunity Tax Credits
- Federal and State Employment Tax Credits
- Research & Development Tax Credits
- 179D Energy Tax Deductions
- Cost Segregation
- Property Tax Exemptions
- Sales Tax Exemptions

Pre-approval (Prior action required)

- Job Creation Tax Credits
- Wage Subsidies
- State Employment Tax Credits
- State Enterprise Zones
- Training Grants/Tax Credits
- Training Assistance

Discretionary (Negotiation required)

- Tax Incremental Financing
- Utility Discounts
- Property Tax Abatements/Exemptions
- Sales Tax Exemptions
- Cash Grants/Financing
- Training Grants



R&D Tax Credit...What is it?

Incentive to **spur innovation** that creates jobs and keeps the U.S. competitive

Income tax credit that can provide a dollar-for-dollar reduction in a company's federal tax liability

Receive a tax credit of as much as 20% of qualified research and development expenses

Federal R&D Tax Credit



- ✓ Annually, **16,000+ companies** report over **\$15 billion** in federal R&D credits...
- ✓ And only **less than 10% of corporations** under \$100M in revenue claim the R&D Tax Credit
- ✓ Capturing the credit is **not limited to a specific industry**

Industries Served



Aerospace



Agriculture



Architecture



Automotive



Breweries



Construction



Energy



Engineering



Food & Beverage



Foundries



Healthcare & Assisted Living



Hospitality



Information Technology



Manufacturing



MEP/HVAC Contractors



Medical Devices



Oil & Gas



Pharma & Life Sciences



Professional Services



Restaurant & Food Franchises



Retail & Distribution



Software



Staffing



Wineries & Vineyards

“Research” = The Four-Part Test

1 New or Improved Business Component

- Product
- Process
- Computer Software
- Technique
- Formula
- Invention

2 Elimination of Uncertainty

- Activity to discover information and eliminate technical uncertainty regarding one of:
- Capability
 - Methodology
 - Appropriateness of the business component design

3 Process of Experimentation

- All activities must relate to a process of experimentation:
- Evaluating alternative designs
 - Testing hypothesis
 - Systematic trial and error/modeling

4 Technological in Nature

- Activity must fundamentally relate to science:
- Physical sciences
 - Biological sciences
 - Computer sciences
 - Engineering

Qualified Activities



- ✓ Concept development
- ✓ Feasibility evaluation
- ✓ Specification design
- ✓ Experimental prototypes development
- ✓ Design test and execution
- ✓ Design refinement
- ✓ Beta testing
- ✓ Prototypes refinement
- ✓ Technical design reviews
- ✓ Technical meetings
- ✓ Technical writing
- ✓ Compiling research data
- ✓ Research documentation preparation
- ✓ Direct supervision/ support of research

Non-Qualified Activities

- × Capital expenditures
- × Training
- × Routine or maintenance activities
- × Activity conducted outside U.S.
- × Activities in social sciences, arts and humanities
- × Research after commercial production
- × Advertising or promotional activities
- × Reverse engineering
- × Funded research (grants and contracts)
- × Selling existing products
- × Travel and admin expenses
- × Routine data collection
- × Efficiency surveys
- × Activity related to a management technique
- × Marketing or market research
- × Adapting or duplicating an existing component
- × Other general and administrative tasks

Qualified Research Expenses (QRE)

Salaries and Wages

- Majority of credit is usually wage based (W-2 Box 1)
- Direct supervision and direct support

Supply Costs

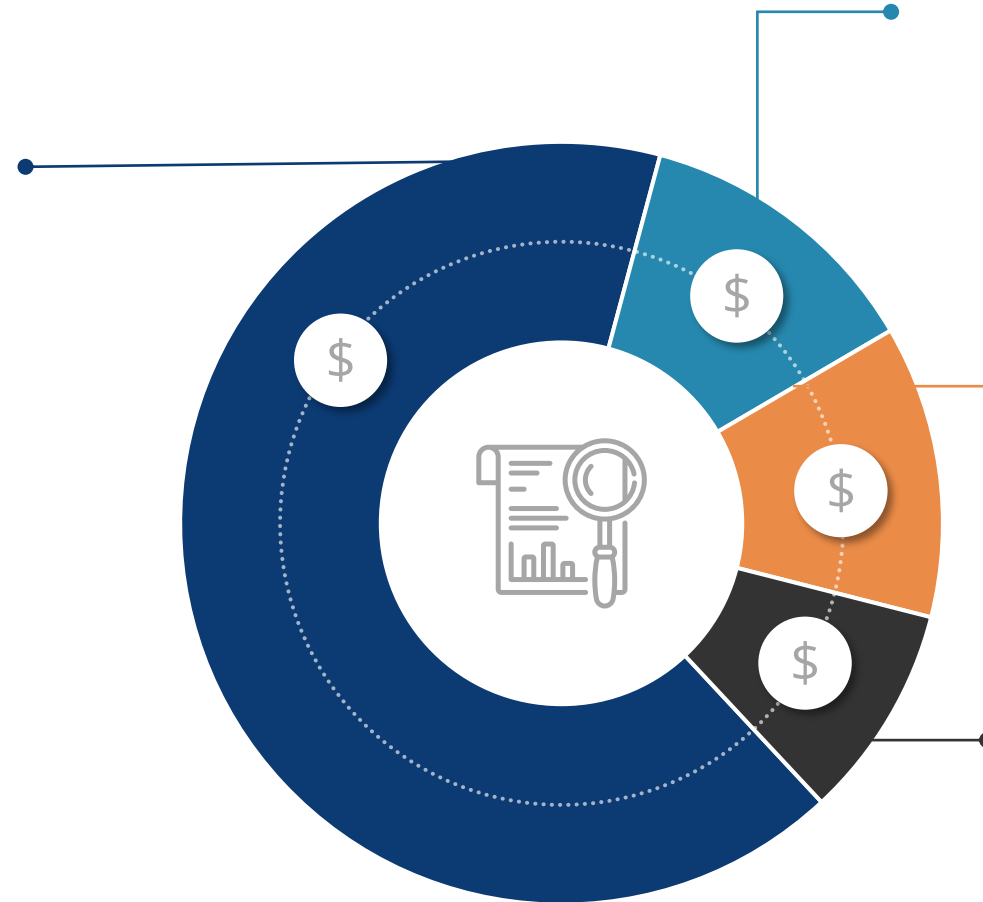
- Used or consumed during research and experimentation

Contractor Costs

- 65% of qualifying costs eligible
- Rights and risks

Rental or Lease of Computer

- e.g., Cloud computing costs



Federal R&D Tax Credit Calculations

Enacted in 1981 under Internal Revenue Code Section 41, The federal R&D credit provides an incremental income tax credit under two possible calculation methods:

- (1) A **regular credit** calculation provides a credit equal to 20% of a company's current year qualified research expenses (QREs) that exceed a base amount. It is calculated based upon increases in research activities and expenditures; and it is intended to reward, not static programs but those that pursue innovation with continually increasing investment.
- (2) **Alternative Simplified Credit (ASC)** which equals 14% of the QREs for the taxable year that exceed 50% of the average QREs for the 3 taxable years preceding the credit determination year. The ASC method allows companies to claim research credits if research costs remain the same or even decline when compared with prior years.

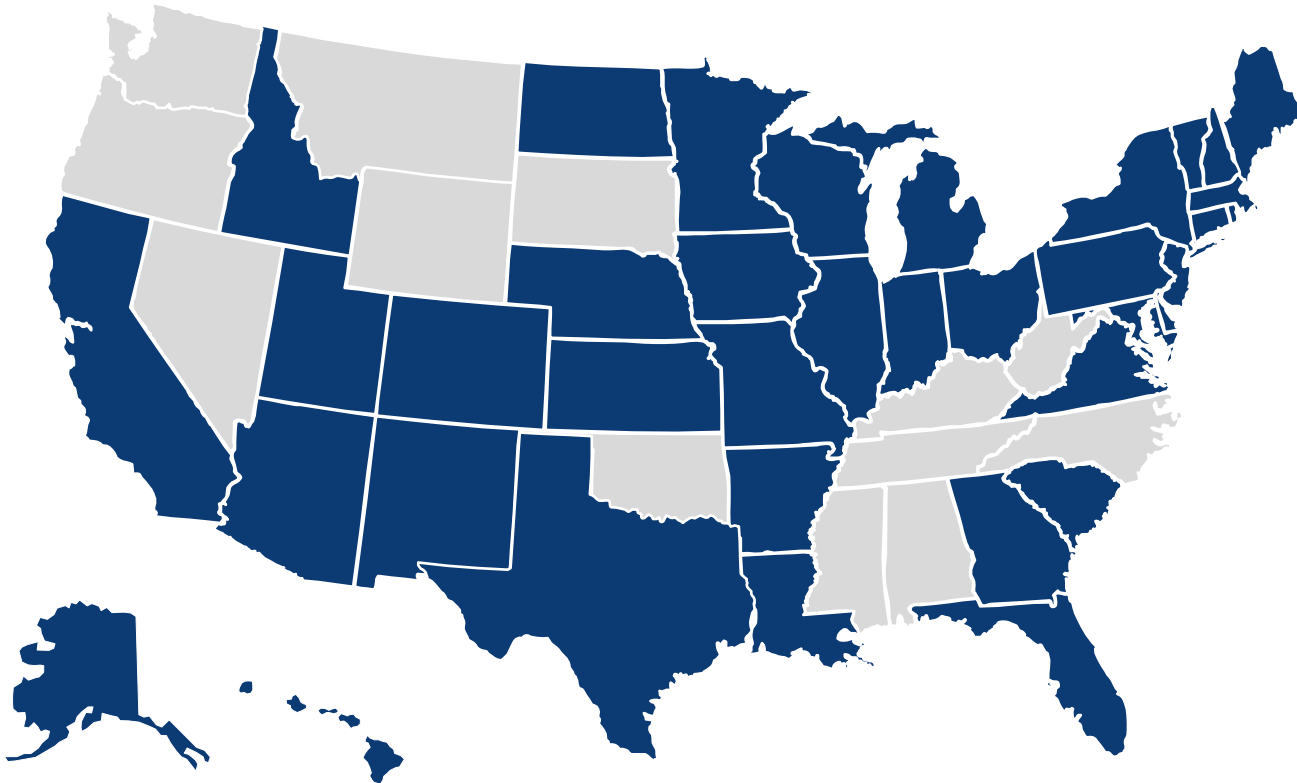
Many states also have R&D tax credits and incentives that generally follow the federal rules, with some exceptions.

Federal Regular Credit Calculation

EXAMPLE A
Regular Credit

Current year QREs:	\$1,000,000
Base amount:	\$250,000
Greater of base amount or 50% current QREs:	\$500,000
Excess of current QREs base amount:	\$500,000
Multiplied by 20% credit rate:	\$100,000
Net credit (280C, reduced by 21%):	\$79,000

State R&D Credits & Incentives



Property, sales & use tax and other incentive opportunities will be considered based on location of R&D activity

State R&D Credit Rates (Examples)

- AZ:** 15% or 24%
- CA:** 15%
- GA:** 10%
- ID:** 5%
- IL:** 6.5%
- IN:** 10% or 15%
- MA:** 10% or 15%
- MD:** 10%
- ME:** 5% or 7.5%
- MN:** 10% of first \$2 million and 4% after
- OH:** 7%
- PA:** 10% or 20%
- SC:** 5%
- TX:** 5% or 6.25%
- UT:** 5% and/or 7.5%
- VA:** 5%, 10%, 15% or 20%
- WI:** 2.875% or 5.75%

Credit Carryforward

- 1 Must carryback the credit one year prior before you can carryforward
 - Review utilization and SOL in that year make any necessary adjustments
- 2 May carryforward up to 20 years
- 3 Statute of Limitations (SOL) applies to the year in which the credit is generated
- 4 Credits are used first in, first out – FIFO

Recent Changes – R&D

LEGISLATIVE, ADMINISTRATIVE, & RECENT CASE LAW UPDATES

Legislative Update

Inflation Reduction Act

- For Tax Years beginning after 12/31/2022 (Tax Years 2023+), the amount a Qualified Small Business (“QSB”) can potentially claim as an R&D start-up tax credit to offset payroll taxes is **increased to a maximum of \$2.5 million over five years (or \$500,000 per year)**. Previously, \$1.25 million over five years (or \$250,000 per year)
 - Additional \$250,000 will offset employer portion of Medicare tax
- Significant IRS funding to improve taxpayer services and enforcement of the tax code

Tax Cuts and Jobs Act (“TCJA”) of 2017

- For Tax Years beginning after 12/31/2021 (Tax Years 2022+), taxpayers are required to capitalize and amortize U.S.-based R&E expenses over a period of five years and non-U.S. R&E expenses over 15 years.
- Capitalization and amortization of R&E expenses begin with the midpoint of the tax year in which the expenses are paid or incurred. Thus, the amortization period is six years for U.S.-based R&E expenses and 16 years for non-U.S. expenses.
- Likelihood of legislation to repeal, delay or otherwise modify change in treatment of R&E expenses?

Administrative Update

Field Advice Memorandum 2021410F

- As of 1/10/2022, additional information supporting the R&D tax credit must be provided for all amended refund claims in order to be valid
- This does not impact R&D tax credit claims on originally filed returns (including extensions)
- Additional information that is required includes enumeration of qualified R&D projects (business components), activities, and job titles.
- Transition period for amended research credit refund claims filed during the period January 10, 2022, through January 9, 2024, during which taxpayers will have 45 days to perfect a research credit claim for refund that is deemed deficient because it failed to provide the minimum criteria prior to the IRS' final determination on the claim.

Recent R&D Case Law

	Issue	Takeaway
United States v. Grigsby (2022)	Funding (substantial rights)	Thorough contract review is necessary for the funding analysis, including properly identifying the business component and evaluating the scope of the defined work product and ownership rights transferred.
Tangel v. Commissioner (2021)	Funding (substantial rights)	The court applied Lockheed to find that the company did not retain substantial rights because all technical information generated as well as any copyright and patent ownership are transferred to client.
Little Sandy Coal Company v. Commissioner (2021)	Substantiation	Importance of substantiation of activities and expenses, particularly contemporaneous documentation that demonstrates and supports the process of experimentation requirement of 4-Part Test.
Meyer, Borgman & Johnson, Inc. v. Commissioner (2020)	Funding (economic risk)	Terms and conditions within any contract are most important when establishing risk and rights. No implications or assumptions outside the four corners of the contract should be considered.
Populous Holding, Inc. v. Commissioner (2019)	Funding (economic risk & substantial rights)	Companies paid on a fixed priced basis to develop and deliver final products establish economic risk. Absence of provisions in a contract prohibiting a company from using the research it performed constitutes retention of substantial rights.
Siemer Milling Company v. Commissioner (2019)	Substantiation	Importance of document retention and ability to provide contemporaneous records that support the 4-Part Test.

Mandatory Capitalization of R&E Costs



What are Section 174 Expenditures?

- Research or experimental expenditures (R&D) are expenditures paid or incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense, i.e., for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.
 - Capability: can it be done?
 - Method: how can it be done?
 - Design: what is the appropriate design?
- The term “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.
- Section 174 generally includes all costs incident to the development or improvement of a product, and its therefore more expansive in scope than “qualified research expenses” under Section 41.
- While Section 41 only allows wages, supplies, contract research and computer rental expenses to be included in the computation of the credit, Section 174 expenses can include items such as utilities, depreciation, attorneys' fees and other costs incident to the development or improvement of a product.

Sec. 174 R&E Costs vs Section 41 QREs

Research Expenses Type	Sec. 174 Costs (Capitalization and Amortization)	Sec. 41 QREs (Included for R&D Tax Credit)
Wages, supplies and computer rental expenses	INCLUDED	INCLUDED
Contractors- Outside Service providers	INCLUDED	PARTIALLY INCLUDED
Supervision	INCLUDED	PARTIALLY INCLUDED
Rent, utilities and overhead	INCLUDED	EXCLUDED
Equipment depreciation	INCLUDED	EXCLUDED
Patent-related expenses	INCLUDED	EXCLUDED
Foreign Research	INCLUDED	EXCLUDED

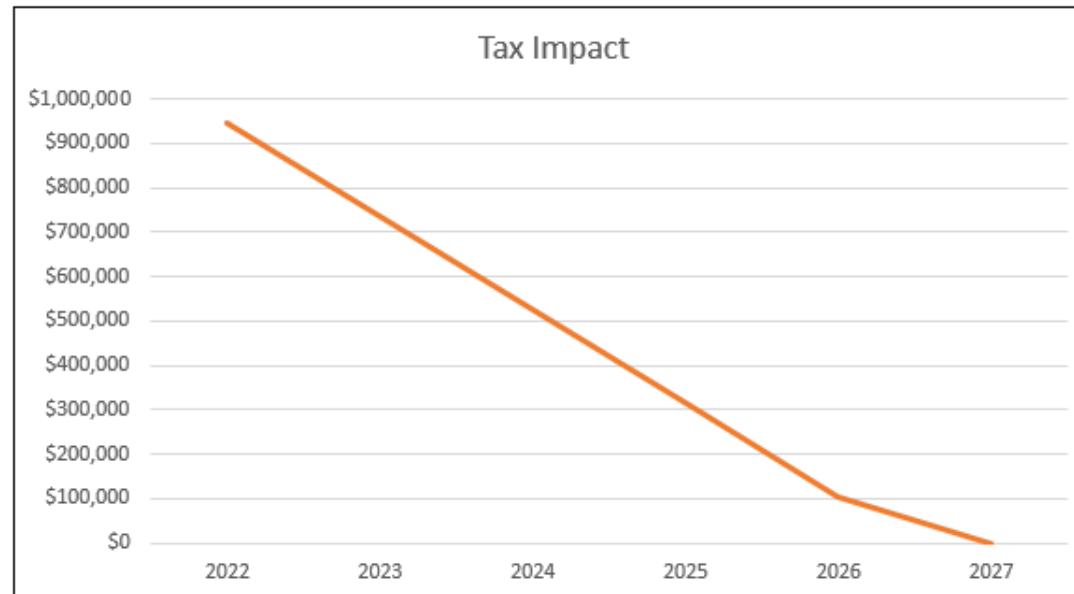
Sec. 174 Capitalization and Amortization

Example 1

Example 1: taxpayer conducts all R&E in the US and does not increase its R&E spend year over year

	2022	2023	2024	2025	2026	2027
Current Section 174 Expenditures	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000	\$5,000,000
Amount Recovered	(\$500,000)	(\$1,500,000)	(\$2,500,000)	(\$3,500,000)	(\$4,500,000)	(\$5,000,000)
Remains Capitalized	\$4,500,000	\$3,500,000	\$2,500,000	\$1,500,000	\$500,000	\$0
Tax Rate	21%	21%	21%	21%	21%	21%
Additional Tax Impact	\$945,000	\$735,000	\$525,000	\$315,000	\$105,000	\$0

Y1 impact is significant due to midyear convention, effectively allowing only 10% of what would otherwise have been deducted. Assuming a flat Research and Experimental Expenditures spend year over year, the impact will gradually decline until phasing out in year 6.



5-Year Impact of Sec. 174 and R&D Tax Credit

Tax Year	Credit	R&E expenses	Increase in taxable income	Tax rate	Additional tax without the FED R&D tax credit	Additional tax with the FED R&D tax credit
2022	\$300,000	\$5,000,000	\$4,500,000	21%	\$945,000	\$645,000
2023	\$300,000	\$5,000,000	\$3,500,000	21%	\$735,000	\$435,000
2024	\$300,000	\$5,000,000	\$2,500,000	21%	\$525,000	\$225,000
2025	\$300,000	\$5,000,000	\$1,500,000	21%	\$315,000	\$15,000
2026	\$300,000	\$5,000,000	\$500,000	21%	\$105,000	\$0
Total					\$2,625,000	\$1,320,000
DIFF						\$1,305,000

For a taxpayer that isn't currently claiming the R&D tax credit, a savings of \$1,305,000 is realized. For a taxpayer already claiming the R&D tax credit, no additional savings would be realized. However, the taxpayer would be able to continue realize its current benefit from claiming the R&D tax credit. If the taxpayer discontinues claiming the R&D tax credit, their tax liability would increase by the amount of the R&D tax credit lost *plus* the tax liability increase from the change in the treatment in Section 174 R&E expenditures.

No savings would be realized by a taxpayer currently claiming the R&D tax credit to discontinue claiming the credit. The impact of the Sec. 174 R&E capitalization and amortization requirement and the R&D tax credit are mutually exclusive of each other.

Questions?



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Taylor Melton

Director, R&D Technical Sales

tmelton@ctillc.com

(832) 306-6144

Nick Panzarella

Associate Director

npanzarella@ctillc.com

(832) 352-9295



@CorporateTaxIncentives



@Corporate Tax Incentives



@cti_llc