R&D TAX CREDIT UPDATE: POLICY AND PERSPECTIVES

Updates to R&D tax policy

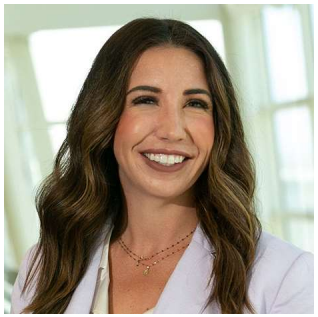
July 20, 2023

With you today

Dave Kautter

Partner, RSM US

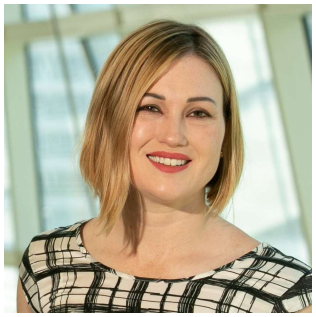
Dave is RSM's federal specialty tax leader. He served the US Department of Treasury as its assistant secretary for tax policy from 2017-2021. Dave also served as acting commissioner of the IRS from 2017-2018.



Dana Jackson

Partner, RSM US

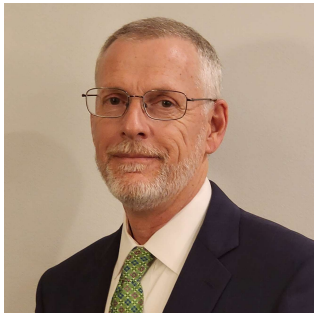
Dana is the national Federal Credits & Incentives leader for RSM. She delivers advice and consultation regarding a wide variety of issues in federal credits and incentives.



Ashley Zega

Partner, RSM US

Ashley has more than 15 years experience in tax, with a primary focus working with sections 41 and 174. Ashley serves clients in a variety of industries and works with all aspects of federal credits and incentives.



David Hudson

Senior Director, RSM US

David has more than 30 years of experience working with sections 41 and 174, both within the IRS and in public accounting.

Agenda

- Updates to R&D tax policy—Section 174
- Updates to R&D tax policy—Interplay of sections 174, 41, and 280C
- Research credit—Recent court cases that may impact how taxpayers determine and substantiate research credits
- IRS and state taxing authority activity

Background: Updates to R&D tax policy—Section 174

Two types of "research and experimentation" tax incentives

- Deductibility (Section 174)
- Credits (Section 41)

Dec. 2017

- President Trump signs into law Tax Cuts and Jobs Act, which changed the ability to immediately deduct research expenses
- Requires capitalization and amortization over 5 or 15 years, depending on where research is conducted
- Research cost capitalization provision has deferred effective date

Winter/Spring/ Summer 2022

- Required capitalization for research costs begins (for tax years beginning after 12/31/2021)
- Various legislation introduced to repeal or defer required capitalization of research costs
- Despite broad bi-partisan support in Congress for repeal/deferral, Congress adjourns in December without changing the capitalization rule

Spring/Summer 2023

- Research expense change remains tied to interest expense change, capital equipment change and child tax credit change
- House Republicans pass measure through the Ways & Means Committee that includes a provision addressing section 174, providing retroactive relief to year of change
- Senate passage primarily dependent on child tax credit, thus setting up potential year end tax activity

Interplay of sections 174, 41, and 280C

- Section 41 “qualified research expenses” (QREs) are usually a subset of section 174 “specified research or experimental expenditures” (section 174 costs).
- A taxpayer may have section 174 costs even if it has no QREs or claims no research credit under section 41.
- Section 280C(c)(1) provides that if the amount of the credit for the year exceeds the amount allowable as a deduction for such year for QRES, then the amount chargeable to capital account for the taxable year for such expenses shall be reduced by the amount of such excess.
- If section 280C(c)(1) applies, section 280C(c)(2) allows a taxpayer to elect out of section 280C(c)(1), with an irrevocable election.

Interplay of sections 174, 41, and 280C

Taxpayer with Increasing QREs over Its Base in the Alternative Simplified Credit Calculation (applying old law)

Year	174 Costs	QREs				
2019	$200,000	$100,000				
2020	$220,000	$110,000				
2021	$240,000	$120,000				
2022	$260,000	$130,000				
			Reduced Credit NOT Elected		Reduced Credit Elected	
Full Research Credit w/out Section 280C	$10,500		Amount of the Research Credit under Section 280C(c)(1)	Amount of the Section 174 Deduction under Section 280C(c)(1)	Amount of the Research Credit under Section 280C(c)(3)	Amount of the Section 174 Deduction under Section 280C(c)(3)
2022 Section 174 Deductible Amount w/out Section 280C	$260,000		$10,500	$249,500	$8,295	$260,000

Interplay of sections 174, 41, and 280C

Taxpayer with Increasing QREs over Its Base in the Alternative Simplified Credit Calculation (applying new law)

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			Reduced Credit NOT Elected		Reduced Credit Elected	
Full Research Credit w/out Section 280C	$10,500		Amount of the Research Credit under Section 280C(c)(1)	Amount of the Section 174 Amortization under Section 280C(c)(1)	Amount of the Research Credit under Section 280C(c)(2)	Amount of the Section 174 Amortization under Section 280C(c)(2)
2022 Section 174 Amortizable Amount w/out Section 280C	$260,000		$10,500	$26,000	$8,295	$26,000

Interplay of sections 174, 41, and 280C

- What if Congress retroactively repeals the changes to section 174?
- What if Congress retroactively repeals the changes to section 280C(c)?

Recent cases impacting the research credit

Betz v. Comm'r, T.C. Memo. 2023-84 (July 6, 2023)

Facts

- Taxpayers were shareholders (and some were employees) in an S corporation that designs, builds, and installs primarily custom catalytic and thermal oxidizing air pollution control systems that eliminate harmful airborne manufacturing byproducts (e.g., like volatile organic compounds).
- Taxpayers claimed a research credit based on QREs claimed with regard to 19 projects undertaken by the S corporation to design, build, and deliver custom pollution control systems for its customers. The QREs for these projects included $1,983,647 in wages and $5,732,211 supply costs.
- The bulk of the QREs were for the costs of constructing the systems installed at the customers' business, which included integrated components purchased from third-party vendors.
- The taxpayers asserted that because each system delivered to the customer was "uniquely designed for the particular application on which it is being designed," each system was a "pilot model," with the costs of production qualifying under section 174 until the system was "running in a manner which meets the project requirements."

Recent cases impacting the research credit

Betz v. Comm'r, T.C. Memo. 2023-84 (July 6, 2023)

Facts

Taxpayers' position effectively relied an argument consistent with Example 7 of section 1.174-2(a)(11):

> X is a manufacturer of aircraft. X is researching and developing a new, experimental aircraft that can take off and land vertically. To evaluate and resolve uncertainty during the development or improvement of the product and test the appropriate design of the experimental aircraft, X produces a working aircraft at a cost of $5,000,000. The $5,000,000 of costs represents research and development costs in the experimental or laboratory sense. In a later year, X sells the aircraft. Because X produced the aircraft to resolve uncertainty regarding the appropriate design of the product during the development of the experimental aircraft, the aircraft is a pilot model; therefore, the $5,000,000 of costs that X incurred in producing the aircraft qualifies as research or experimental expenditures under section 174.

Recent cases impacting the research credit

Betz v. Comm'r, T.C. Memo. 2023-84 (July 6, 2023)

Court's analysis

- The court focused primarily on the section 174 test in evaluating the application of the four-part test under section 41 for defining qualified research, in evaluating whether the S corporation's activities were eligible for the research credit.
- The court did not accept taxpayers' argument that the substantial costs of implementing the designs were "investigative," with the purpose of discovering information about whether those designs as a whole were appropriate, and concluded that the claimed supply QREs incurred in the actual production of the oxidizers were not deductible under section 174. Having failed the section 174 test, these costs were not "incurred for supplies used in the conduct of qualified research" and thus are not creditable QREs.

Recent cases impacting the research credit

Betz v. Comm'r, T.C. Memo. 2023-84 (July 6, 2023)

Court's analysis

The court noted that this conclusion would not necessarily mean the end of the inquiry, as the section 174 regulations provide a shrinking-back rule that would require the court to next analyze whether any particular components or subcomponents of taxpayers' systems were pilot models, discretely constructed with the purpose of evaluating and resolving uncertainty. Section 1.174-2(a)(5). However, the court found that taxpayers failed to carry their burden of establishing that any particular components or subcomponents were pilot models.

Recent cases impacting the research credit

Betz v. Comm'r, T.C. Memo. 2023-84 (July 6, 2023)

Court's analysis

For one project the court noted that the decisions to make certain design changes to the system may well have implicated objective uncertainty and investigative activities. However, on the record before it, the court stated that it was "unable to bridge the vast evidentiary gap [taxpayers] left." Aside from taxpayer's vague testimony, taxpayers' failure to produce evidence as to what investigative activities were performed, which prevented the court from applying the shrinking-back rule. "Even if [taxpayers] had established that activities performed with respect to these two components satisfied the section 174 test, they also failed to identify the activity-performing . . . employees and thus did not provide a reasonable basis for estimating the amount of corresponding wage" QREs.

Recent cases impacting the research credit

Betz v. Comm'r, T.C. Memo. 2023-84 (July 6, 2023)

Key points

- Establish the uncertainty at the overall product level.
- Document the fact that there may be uncertainty in development process, but be specific on the "investigative" nature of activities for which QREs were incurred, e.g., exactly what things were the pilot models used to test for.
- Vague testimony as to uncertainty and minor examples of product changes at a sub-component level will not be sufficient to make your case.
- The court sustained a 20 percent section 6662 accuracy related penalty!

Recent cases impacting the research credit

Little Sandy Coal Co. v. Comm'r, 62 F.4th 287 (7th Cir. 2023)

Facts

- Taxpayer is a ship builder that claimed the research credit for costs associated with 11 projects that involved building “first-in-class” ships.
- The court looked at two projects that involved $2,651,600 of QREs for production wages, and $5,835,407 of supply cost QREs.
- Taxpayer took an “all or nothing approach” in litigation in that if the court did not allow the total costs associated with each ship, taxpayer would not provide information to allow the court to perform a “shrink-back” analysis.

Recent cases impacting the research credit

Little Sandy Coal Co. v. Comm'r, 62 F.4th 287 (7th Cir. 2023)

Facts

The taxpayer's case largely consisted of:

- Descriptions of new or novel aspects of the two ships reviewed
- Estimates of the amount of time the people who worked on the ships related to the new or novel features
- Information indicating that some of the design people were conducting nonqualified activities like management, customer an supplier relations

Recent cases impacting the research credit

Little Sandy Coal Co. v. Comm'r, 62 F.4th 287 (7th Cir. 2023)

Court's analysis

The court determined the appropriate method for taxpayer to determine whether 80 percent or more its research activities constitute elements of a process of experimentation for a purpose related to a new or improved function, the performance, or the reliability or quality of a business component, under the requirement of section 1.41-4(a)(6).

Recent cases impacting the research credit

Little Sandy Coal Co. v. Comm'r, 62 F.4th 287 (7th Cir. 2023)

Court's analysis

The court found that the equation to determine if the activities satisfy the 80 percent test is:

$$\frac{\text{The wages of the employees who related to the elements of the process of experimentation}}{\text{The wages of the employees who conducted section 174 activities excluding section 41(d)(4) activities}}$$

Recent cases impacting the research credit

Little Sandy Coal Co. v. Comm'r, 62 F.4th 287 (7th Cir. 2023)

Court's analysis

- Because the test in the regulations is based on "activities" the court found that wages of the employees performing those activities was the best method of performing the substantially all analysis.
- The process of experimentation test is satisfied comes down to whether substantially all of the pilot model production expenses are elements of a process of experimentation.

Recent cases impacting the research credit

Little Sandy Coal Co. v. Comm'r, 62 F.4th 287 (7th Cir. 2023)

Court's analysis

- The 7th Circuit rejected the tax court's analysis, which concluded that the elements of the process could not include any direct support or supervision activities; thus, the people who build a prototype used in testing do not count in the numerator of the "sub all" equation.
- The 7th Circuit stated that the costs of employees that performed the qualified research as well as the employees who provided qualified services through direct support and direct supervision of the research could be included in the numerator of this equation, as long as the people who provided the direct support and direct supervision were related to the elements of a process of experimentation. In this case, the direct support activities included the activities of the ship construction personnel who actually fabricated the tanker barge and the dry dock could be part of the elements of a process of experimentation if the ships were pilot models.

Recent cases impacting the research credit

Little Sandy Coal Co. v. Comm'r, 62 F.4th 287 (7th Cir. 2023)

Court's analysis

- The process of experimentation test is distinguished from the section 174 test in that the former "imposes a more structured method of discovering information."
- The court found that taxpayer had provided insufficient evidence to include the alleged pilot model production expenses for the projects in the numerators of the respective fractions.

Recent cases impacting the research credit

Little Sandy Coal Co. v. Comm'r, 62 F.4th 287 (7th Cir. 2023)

Key points

- The 7th Circuit rejected the tax court's much more restrictive view.
- The 7th Circuit emphasized the difference between the process of experimentation and section 174 test.

Recent cases impacting the research credit

Little Sandy Coal Co. v. Comm'r, 62 F.4th 287 (7th Cir. 2023)

Key points

Granted, whether expenses are deductible under section 174 depends on activities covered by the expenditures, and not on the level of technological advancement. See section 1.174-2(a)(1). But while the degree of technological advancement may not matter, the goal of the research activity must still be development or improvement. "The presence of uncertainty concerning the development or improvement of certain components of a product does not necessarily indicate the presence of uncertainty concerning the development or improvement of other components of the product or the product as a whole." § 1.174-2(a)(5). (Citations omitted.)

Recent cases impacting the research credit

Little Sandy Coal Co. v. Comm'r, 62 F.4th 287 (7th Cir. 2023)

Key points

- Put a different way, a manufacturer may not simply "add a few new bells and whistles" on a pre-existing product and claim uncertainty as to the whole.
- If summed up in one word, expenses deductible under section 174 must be "investigative."
- Documenting the uncertainty related to what you plan to develop (including integration risk/uncertainty) is critical to making this case.

Recent cases impacting the research credit

U.S. v. Leonard L. Grigsby et al., (NO. 3:19-CV-00596, Oct. 19, 2022)

Issues: On a motion for summary judgment by the government to dismiss the case, the court considered whether (1) taxpayer's research was funded by taxpayer's customers under section 41(d)(4)(H), and (2) whether there was a factual dispute about what taxpayer's "business component" were.

Held: (1) The taxpayer's research was fully funded. (2) With regard to the business component issue, the court accepted the government's factual case, as it appeared taxpayer was changing its description of its business components from "products" to "processes."

Recent cases impacting the research credit

U.S. v. Leonard L. Grigsby et al., (NO. 3:19-CV-00596, Oct. 19, 2022)

While both a “product” and a “process” can be a business component under section 41(b)(2)(B), the taxpayers’ lack of specificity in describing its business components clearly presented a problem for the court, and changing its characterization of the business components late in the litigation process convinced the court to accept the government’s representation of the facts. Thus, the court found that there was no material dispute in the facts and granted the government’s motion for summary judgment.

Recent cases impacting the research credit

Harper v. Comm'r, T.C. Memo 2023-57 (May 10, 2023)

Issue: What may be treated as a business component for purposes of the research credit under section 41(b)(2)(B)?

Held: The court concluded, based on the factual record before it, that taxpayer may have conducted research to develop new or improved processes, techniques, and possibly inventions that it used in its construction business.

Recent cases impacting the research credit

Harper v. Comm'r, T.C. Memo 2023-57 (May 10, 2023)

The court rejected the IRS's theories that:

- The buildings and facilities constructed by taxpayer never belonged to taxpayer, yet only these structures (and not the designs created by taxpayer) were "new or improved."
- Taxpayer's designs were not "products," as that word is intended in the statute, but rather "tangible manifestation[s] of construction services."
- Neither taxpayer's designs nor the facilities it constructed were ever "held for sale" by taxpayer.
- Taxpayer did not "use" its designs in the sense intended by the statute, because Congress meant for taxpayers' use of business components to be "meaningful" so as to change taxpayer's day-to-day operations."

Recent cases impacting the research credit

Harper v. Comm'r, T.C. Memo 2023-57 (May 10, 2023)

Rejecting the government's arguments, the court concluded, based on the factual record before it, that the taxpayer may have conducted research to develop new or improved processes, techniques, and possibly inventions that it used in its construction business, and the court denied the government's motion for summary judgement.

Recent cases impacting the research credit

Stephens v. Comm'r, 2022 U.S. Tax Ct. LEXIS 910

- Citing *TG Missouri Corp. v. Comm'r*, 133 T.C. 278 (T.C. 2009) the court found that the fact that supplies were purchased for the purpose of constructing a final product for delivery to a customer does not preclude those supplies from being QREs. Whether they are, in fact, QREs is a question to be resolved at trial.
- Thus, the court denied the IRS motion of summary judgement.

Recent cases impacting the research credit

Moore v. Comm'r, T.C. Memo 2023-20 (Feb. 23, 2023)

The court held that a corporation's president and COO did not engage in direct supervision or direct support (as provided by section 41(b)(2)(B)(ii)) of persons who performed qualified services during, and even though he was extensively involved in new product development, the record does not show the portion of his work on new product development that met the requirements of "qualified research." Thus, his salary is not eligible as wage QREs in computing the research credit.

IRS and state taxing authority activity

- Unfavorable court cases – expect the issues highlighted to be a focus area for future exams
- Potential changes to Form 6765
- Claiming R&D credit refunds on amended returns – “Specificity requirements”

IRS and state taxing authority activity

- IRS requirements for research credit refund claims
  - FAA 20214101F Sept. 17, 2021
  - Form 6765 instructions
  - Research credit refund claims FAQ 18 (https://www.irs.gov/businesses/corporations/research-credit-claims-section-41-on-amended-returns-frequently-asked-questions)
  - 45 day window to perfect credit claim

IRS and state taxing authority activity

The following five items of information must be identified and provided with your claim.

1. Identify all the business components to which the research credit claim relate for that year.
2. For each business component, identify all the research activities performed.
3. 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.
4. For each business component, describe the information each individual sought to discover.
5. 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. This fifth item may be done by using Form 6765.

IRS and state taxing authority activity

- Most states generally conform to federal rules.
- States that currently do not offer an R&D credit – AK, AL, MI, MT, MS, NC, NV, OK, OR, SD, TN, WA, WV, WY.
- Alabama – state credit proposed in recent bills.
- Connecticut – single member LLCs ineligible for state research credit.
- Iowa – over last few years Iowa has changed credit rules and starting to deviate from federal; by year 2027 supplies will no longer be an eligible cost.
- Ohio – limited opportunity for construction industry.
- Texas – significant documentation requirements; difficult to claim software R&D.

Resources

Don’t forget about our resources…..

[Research and development tax credit | Services | RSM US]

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