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US/ UK webinar series - cross border opportunities for investment in R&D

THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING



Your speakers



James Tetley
Innovation Reliefs Partner, RSM UK
james.tetley@rsmuk.com



Flora Barnes
Tax Director, RSM UK
flora.barnes@rsmuk.com



Mike Fletcher
Tax Partner, Enterprise Account Leader,
RSM US
mike.fletcher@rsmus.com



Ashley Zega
Credits & Incentives Partner, RSM US
ashley.zega@rsmus.com



Danielle Kaufman
Credits & Incentives Partner, RSM US
danielle.kaufman@rsmus.com



Kathleen Koehl
Innovation Reliefs Manager, RSM UK
kathleen.koehl@rsmuk.com

Today's agenda



- 1 Overview of regimes - UK
- 2 Overview of regimes - US
- 3 IRC §174 capitalization
- 4 Changes to UK R&D tax reliefs
- 5 Current regulatory environment
- 6 Cross-border considerations

Tax landscape update



UK:

- Economic situation means more interest in loss use as businesses look to use losses made during covid.
- Interest rates remain high, meaning transfer pricing and corporate interest restriction in point for more businesses.
- Inflation is now 6.8% (August) and wage growth also high; specific industries affected.
- Businesses examining home/office/hybrid working and 'the new normal' and tax consequences thereon.
- Election within next 18 months; both parties looking at tax plans. UK tax burden highest in peacetime history at 36.8% of GDP.
- HMRC starting to hold governance-based Business Risk Review processes for the largest businesses (UK turnover £200m+).

US:

- Political processes are currently focused on debt ceiling issues and a potential impeachment proceedings.
- No room in the current dialogue for tax issues, although there is general acknowledgment amongst staffers and members of the House and Senate that issues related to R&D and Interest expense deductibility are in need of a legislative resolution.

Overview of regimes - UK



Overview - UK



- In the UK, R&D tax incentives have been available since 2000 for Small and Medium-sized Enterprises (SMEs) and 2002 for large companies.
- Part of government policy to encourage investment in technological innovation; to make companies more competitive; stimulate job and skills creation; and attract investment in the UK.
- HMRC estimates that for every £1 spent on R&D tax credits, between £0.60 and £2.70 is additionally spent on R&D by UK companies*.
- Undergoing unprecedented change.



* Sources: *Evaluation of Research and Development Expenditure Credit, HMRC Working Paper, 2020*; *Evaluation of the Research and Development Tax Relief for Small and Medium-sized Enterprises, HMRC Working Paper, 2019*

Overview - UK



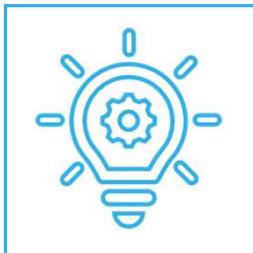
Overview of schemes

	SME	R&D Expenditure Credit (RDEC)
Size criteria	<ul style="list-style-type: none"> • <500 FTE employees, and <ul style="list-style-type: none"> — turnover <€100m; or — gross assets <€86m. 	Not SME
Form of benefit	Enhanced deduction; cash credit	Taxable cash credit
Net benefit	<p>Until 31 March 2023, £24 - £33 per £100 of qualifying expenditure (QE)</p> <p>From 1 April 2023, £18 - £21 per £100 of QE*</p>	<p>Until 31 March 2023, £10 per £100 of QE</p> <p>From 1 April 2023, £15 per £100 of QE</p>

Overview - UK



Definition of R&D for tax purposes



Seek to achieve an
**advance in science or
technology**

- **The extension to overall knowledge** or capability in a field of science or technology:
 - **the development of a new** product, process, or device;
 - the **appreciable improvement** to an existing product, process, or device;
 - the use science or technology to **duplicate the effect** of an existing product, process, or device.
- The advance is measured against knowledge in the **public domain**.
- **Success is not a requirement!**



Seek to overcome
**scientific or technological
uncertainties**

- Uncertainty whether something is scientifically possible or technologically **feasible to achieve**, or the **route to achieving it in practice**:
 - includes scientific and technological uncertainty whether it is possible to achieve the aims in a **cost-effective, reliable, or reproducible manner**;
 - this includes **system uncertainty**.
- The concept of uncertainty marks the **start and end of R&D**.

(DSIT Guidelines on the Meaning of Research and Development for Tax Purposes)



Overview - UK

Qualifying expenditure

Costing Category	SME	RDEC
Staffing costs	✓	✓
Externally provided workers (EPWs)	✓	✓
Subcontracted activities	✓	✗*
Consumable/utility costs	✓	✓
Software licenses	✓	✓
Contributions to independent research	✗	✓
Tax years beginning from 1 April 2023		
Data licenses	✓	✓
Cloud computing services	✓	✓

Overview of regimes - US



Overview - US



- In the US, R&D tax incentives have been available since 1981 and were made a permanent part of the Internal Revenue Code (IRC) in 2015.
- Intended to act as an economic stimulus while encouraging productivity gains and global competitiveness.
- Governed by two IRC sections:
 - §174 defines a R&D expenditure
 - §41 defines the R&D tax credit
- Credit incentivizes increases in (as opposed to total) year over year research spending:
 - typically 5 – 10% of qualified expenditure
 - federal 1-year carry back and 20-year carry forward
 - qualified small businesses may use to offset payroll tax
 - 37 out of 50 states also offer some form of R&D credit





Overview - US

The four-part test to qualify activities

Permitted Purpose

The activity relates to a **new or improved function, performance, reliability, or quality** of a business component (i.e., product, process, computer software, technique, formula, or invention) which is to be held for sale, lease, license, or used in a trade or business.

Technological in Nature

The activity performed must **fundamentally rely** on principles of: physical science, biological science, computer science, or engineering.

Elimination of Uncertainty

The activity must be intended to discover information to eliminate uncertainty concerning the **capability or method** for developing or improving a product or process, or the **appropriateness of the product design**.

Process of Experimentation

Substantially all of the activities must be elements of a **process of experimentation** to resolve the technical uncertainty, documented by explaining: the alternatives considered and attempted, testing performed on the alternatives, test results and analysis.

Overview - US



The three-part test for internal use software

01

Not Commercially Available

The software **CANNOT BE PURCHASED**, leased, or licensed and used for the taxpayer's intended purpose without **SUBSTANTIAL MODIFICATION**.

02

Innovative

The software is intended to be **UNIQUE** or **NOVEL** and must differ in a significant way from prior software. The software must result in significant **COST REDUCTION** or substantial **IMPROVEMENT IN SPEED**.

03

Significant Economic Risk

The taxpayer must commit **SUBSTANTIAL RESOURCES** to the software development, and such resources must be at risk due to **TECHNICAL UNCERTAINTIES**.



Qualifying expenditure

01

Staffing costs: direct performance, direct support and direct supervision.

02

Consumables, extraordinary utilities.

03

Rental costs of computers (cloud computing).

04

Third-party contractors (limited to 65% or 75%).



Overview - US

Credit calculation methods

Two calculation methods: **Regular** and **Alternative Simplified**.

Optimal method depends on information available and how long taxpayer has been in operation.

Regular Method	\$	Alternative Simplified Method	\$
Tax Year R&D Expenditures	125,000.00	Tax Year R&D Expenditures	125,000.00
Fixed Base Percentage	3%	Average R&D Expenditure Previous 3 Years at 50%	50,000.00
Average Annual Gross Receipts Previous 4 Years	600,000.00	Difference	75,000.00
Base Amount	18,000.00	Credit at 14%	10,500.00
Greater of Base Amount or 50% Current Expenditures	62,500.00		
Excess of Current Expenditures over Minimum Base Amount	62,500.00		
Credit at 20%	12,500.00		

IRC §174 capitalization





§174 Capitalization

Definition of a §174 cost

- Expenditures incurred in connection with the taxpayer's trade or business which represent research and development **costs in the experimental or laboratory sense.**
- Includes all such costs incident to the development or improvement of a product and **costs of obtaining a patent.**
- For activities intended to discover information that would **eliminate uncertainty** concerning the development or improvement of a product.
- Depends on the **nature of the activity** to which the expenditures relate, not the nature of the product or improvement being developed.
- The ultimate **success, failure, sale, or use of the product is not relevant.**

Examples of §174 Costs	Examples of Items Excluded from §174
Wages and salaries of researchers	Cost of land and depreciable property
Costs of operating and maintaining research facilities, including overhead	Acquisition of another's patent/model/process
Patent and associated legal costs	Management studies
Costs paid to others for R&D activities	Quality control

§174 Capitalization



01

Prior to 1 January 2022

- Taxpayers had flexibility in treatment of §174 research and experimentation costs:
 - expensed when paid or incurred, according to the method of accounting used in computing taxable income; and
 - capitalize and amortize.
- Research and experimentation costs which are neither treated as expenses nor amortized under §174 must be charged to a capital account.

02

From 1 January 2022

- Tax Cuts and Jobs Act of 2017 changed options available for tax years beginning from 1 January 2022:
 - all domestic § 174 costs capitalized and amortized over five years;
 - all foreign § 174 costs capitalized and amortized over 15 years;
 - no option to expense as incurred for tax purposes; and
 - no write-off if a project is abandoned or disposed of.
- Includes costs “above and beyond” those eligible for R&D tax credit.



§174 Capitalization

Example

Income Statement	Pre-Capitalization	Post-Capitalization
Net Margin	10,000,000	10,000,000
§174 Expenditures (Domestic)	1,500,000	150,000
§174 Expenditures (Foreign)	1,500,000	50,000
Other deductible expenses	<u>3,000,000</u>	<u>3,000,000</u>
Taxable Income	4,000,000	6,800,000
Tax Due (25%)	1,000,000	1,700,000
Less: R&D Tax Credit	<u>170,000</u>	<u>170,000</u>
Net Tax Due	830,000	1,530,000

§174 Capitalization



Implications for taxpayers

- Taxpayers historically in a loss position may quickly convert to having taxable income.
- Difficulty tracking §174 expenditures, especially if R&D tax credit is not claimed and cost centre accounting is not used.
- Uncertainty around level of IRS scrutiny and how long regulation will remain in effect:
 - notice 2023-63 released on September 8, 2023; however additional guidance forthcoming based upon comments.
- Consideration of where IP is held.



Changes to UK R&D tax reliefs



Changes to UK R&D tax reliefs



Expanding eligibility

- In effect for accounting periods beginning from 1 April 2023.
- Cloud computing costs.
- Data license costs.
- Pure mathematics activities.



Tackling abuse

- Advanced Notification Form.
- Additional Information Form.

Merged single scheme from 1 April 2024?

- Single rate of 20% taxable RDEC credit (15% net benefit)
- Projects subsidised, or subcontracted to you – non qualifying
- Costs subcontracted by you – qualifying



Focus on UK innovation

- In effect for accounting periods beginning from 1 April 2024.
- Subcontracted R&D activities must take place in UK.
- Externally provided workers payments must be subject to UK payroll taxes.
- Exceptions exist, but are narrowly defined.

High-intensity SMEs

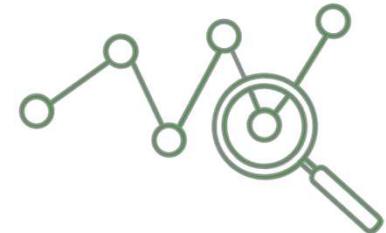
- In effect for accounting periods beginning from 1 April 2023.
- Loss making SMEs can access a 'high intensity R&D' regime.
- Operates on principle of old SME scheme, with payable credit of 27p/£.



Changes to UK R&D tax reliefs

Rates of relief changes

- In effect from 1 April 2023 – may split accounting period



Regime	Pre-1 April 2023	Post 1 April 2023	Benefit
SME profit making	130% uplift	86% uplift	24.7p/£ → 21.5p/£
SME loss making	130% uplift, 14.5% credit	86% uplift, 10% credit	33.3p/£ → 18.6p/£
SME R&D- intensive	130% uplift, 14.5% credit	86% uplift, 14.5% credit	33.3p/£ → 27p/£
RDEC	13%	20%	10p/£ → 15p/£

Current regulatory environment



Changes to US R&D tax reliefs



Nexus

- Definition of business component.
- CCM 20214101F Specificity Requirements.
- Documentation.



Pilot models

- Inclusion of supply costs.
- Shrink back rule.
- Documenting the uncertainty related to what you plan to develop is critical.



Use of estimates

- Anecdotal evidence should 'fill potholes' not 'pave the road'.



Process of experimentation

- Specific identification of investigative activities.
- Less reliance on vague and general statements.

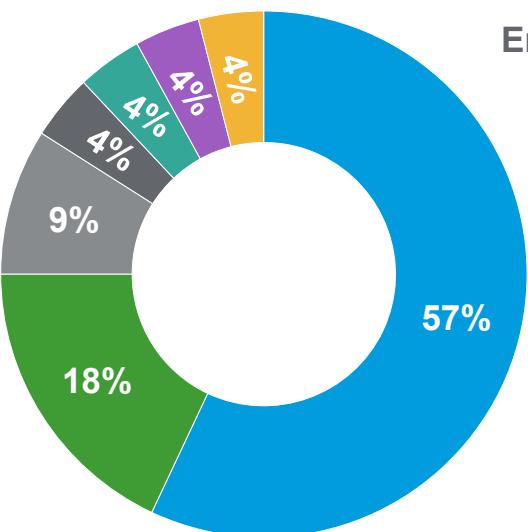
Key areas of IRS focus

- Architecture, engineering, and construction
- Internal use software
- Large prototypes
- Controlled groups



Regulatory environment - UK

Capital vs revenue



EPW vs Subcontract

Nudge letters

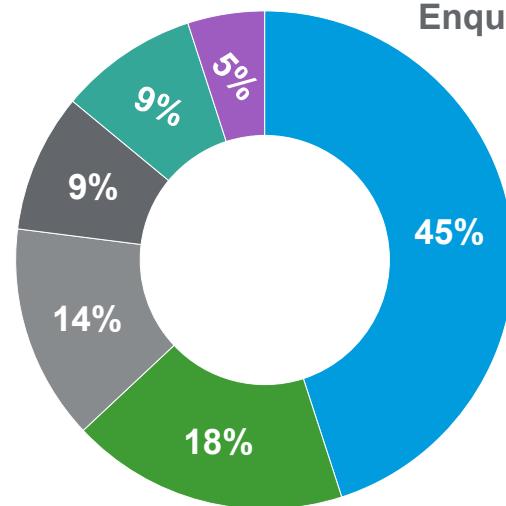
Increase in enquiries



Enquiries by sector

- Software
- Manufacturing
- Engineering
- Biotech
- Hospitality
- Sports
- Chemical technology

Enquiries by size of claim



Cross-border considerations

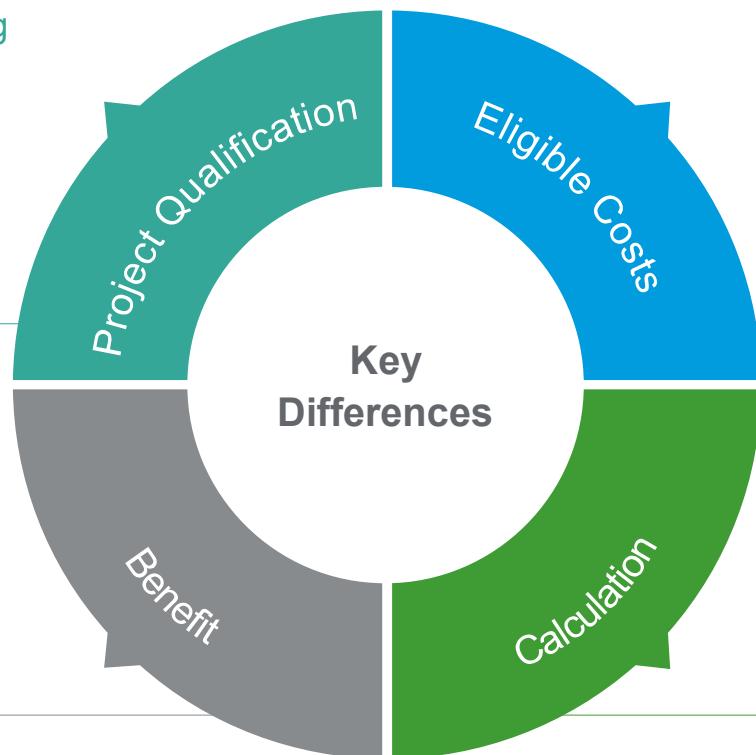


Cross-border considerations



- Commercial project vs. underlying tools & knowledge
- New to taxpayer vs. new to world
- Competent professional
- Internal use software

- Refundability
- Required documentation
- Quantum of benefit



- Scope to include indirect and supporting activities
- Single vs. multiple schemes
- Technology & data costs
- §174 vs. s1308
- Foreign R&D

- Multiple schemes vs. multiple calculation methods
- Absolute vs. increase in expenditure



Cross-border considerations

Takeaways

- 01** ▶ Broadly similar regulations, claims process, and regulatory environment
- 02** ▶ However, the technical requirements and the practical operation can vary significantly by country. Taxpayers who capture information real-time have an advantage in identifying and maximizing their claims.
- 03** ▶ Recent regulatory changes make R&D planning and multinational credit optimization a priority. RSMi's global R&D group can help with this.
- 04** ▶ Further regulatory changes are expected, so continue to watch this space



Any questions?





Thank you for joining us today