Research Tax Credit: Tech, TCJA, IRS Campaign and More

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Agenda – Research Credit

Topic	Content	Presenters
What's New	**Court Cases** –Michael Washburn **Payroll Tax Credit**– Michael Washburn **LB&I Compliance Campaign-Research Issues** –Cheryl Teifer **State tax credit updates** – Matt Normington **Impact of TCJA**– Travis Riley	Michael Washburn Cheryl Teifer Matt Normington Travis Riley
ASC 730	**Overview of ASC 730 and new guidance**– Dan Mennel **Statistics and insights on the program -** IRS How many companies are using it? Industries using it? Is it having the intended outcome of both TP's and the IRS? What can clients be going better to prepare documentation? Disallowed QRE on exam (IRS audit insights) **Practical Implications of ASC 730 on exam -** Matt, Dan, Travis	Dan Mennel Cheryl Teifer Matt Normington Travis Riley

What's New? Court Cases & Payroll Tax Credit

Michael Washburn

Case Update

- *United States v. Quebe*, Dkt. No. 3:15-cv-294 (S.D. Ohio Jan. 17, 2019), 2019 WL 250602 (granting Government's MSJ and holding that taxpayer failed to prove it qualified to calculate credits using I.R.C. § 41(c)(3)(B) applicable to start-up companies).

- *Siemer Milling Co. v. Commissioner*, T.C. Memo. 2019-37 (taxpayer failed to prove it conducted qualified research on certain business components by failing to establish that it satisfied the process of experimentation requirement with respect to any of its projects; in addition, taxpayer failed to establish that some of its projects met the section 174, business component, and/or technological information tests).

- *Swat-Fame, Inc.* 2020-OTA-046P (March 22, 2019) (Cal.Off.Tax App.), 2019 WL 9050584 (taxpayer failed to prove substantially all of its activities were part of a process of experimentation for a qualified purpose; among other things, it did not prove it conducted methodical processes of experimentation rather than simple trial and error).

- Order, *Populous Holdings v. Commissioner*, (T.C. Dkt. No. 405-17) (Dec. 6, 2019) (granting taxpayer's MSJ and holding that research was not funded as (1) taxpayer bore financial risk of research's failure under fixed-price contracts and (2) taxpayer retained substantial rights as there were no provisions that prevented it from using the research or that required it to pay to do so).

- *Audio Technica v. United States*, 963 F.3d 569 (6th Cir. 2020) (government not barred by settlements of prior year claims from arguing fixed-base percentage was incorrect).

I.R.C. §§ 41(h) and 3111(f), payroll tax credit

- I.R.C. § 41(h)(1) allows a "qualified small business" to elect to apply I.R.C. § 3111(f) to the payroll tax credit portion of the credit otherwise determined under I.R.C. § 41(a) for the taxable year and such portion shall not be treated (other than for purposes of I.R.C. § 280C) as a credit determined under section 41(a).
- I.R.C. § 3111(f)(1) provides that, if elected, there shall be allowed as a credit against the tax imposed by section 3111(a) (the employer portion of OASDI (social security tax)) for the first calendar quarter which begins after the date on which the taxpayer files the return with respect to income tax (the election is made on a Form 6765 attached to such return).
- The credit shall not exceed the tax imposed by section 3111(a). I.R.C. § 3111(f)(2).
- The credit carries forward. I.R.C. § 3111(f)(3).
- Generally, a "qualified small business" is (1) corporation or partnership with modified I.R.C. 448(c)(3) gross receipts of less than $5,000,000 and no gross receipts preceding the 5-taxable-year period ending with such year or (2) any person who meets such gross receipts limitations (taking into account aggregate gross receipts from all trades or businesses), but not 501 organizations.
- Among other limitations, the amount specified in an election is capped at $250,000. I.R.C. § 41(h)(4)(B)(i).
- *See also* Notice 2017-23, 2017-16 I.R.B. 1100.

What's New –LB&I Compliance Campaign – Research Issues

Cheryl Teifer

Campaigns

- What is a campaign?
  - A holistic response to compliance risk
  - Resources
  - Treatment streams
- Four guiding principles
  - Cultivate environment of continuous learning
  - Use data analytics and examiner feedback
  - Employ an integrated set of tailored treatment streams
  - Drive continual collection and analysis of data and feedback
- How campaigns function
  - Harnessing the combined intellect of our team
  - A fundamental change
  - Drive specific compliance objectives
  - Improve our understanding of risk
- How we measure success
  - Metrics
  - Impact
  - Research
  - Improved compliance

Research issues campaign external announcement 2/27/2020

- Practice area: Eastern Compliance and Enterprise Activities
- Executive lead/owner: Cheryl Teifer, director, Field Operations Engineering and Joe Banks, acting director, Corporate Issues and Credits
- Campaign point of contact: Trent Museus and Kathleen Giese
- The research issues campaign will address research credit and research and experimental expenditures issues. Issues involving the research credit and research and experimental expenditures under IRC §§ 41 and 174 are some of the most prevalent tax issues within Large Business and International, utilizing significant examination and taxpayer resources. The campaign will employ various treatment streams including issue-based examinations, form updates, and requests for guidance. Other treatment streams will be considered as the campaign progresses. The campaign objective is to promote voluntary compliance, focus resources on the highest-risk research issues, and increase consistency of examinations
- <u>External announcement</u>
- Goals of the research issues campaign (RIC) are:
  - To conduct issue-based examinations using filtering techniques to identify high-risk returns;
  - To promote consistency of examinations and voluntary compliance through proper issue development; and.
  - Based on information gathered from examinations, request additional guidance and/or form updates to assist with reporting and auditing of research issues.

Research issues campaign external announcement 2/27/2020 (cont.)

- RIC core team includes executive leads, senior manager and frontline manager specialists, senior manager and frontline manager GBC practice network, subject matter experts, engineers, counsel, geographic practice area frontline manager liaisons, and other specialists, such as computer audit specialists
- The RIC core team supports examination teams by:
  - Assisting with the identification of research credit sub issues
  - Providing guidance, training, and resources; and
  - Aiding with specialist assignments
- Campaign cases are in the process of being assigned to exam teams

What's New – State tax credit updates

Matt Normington

State R&D Tax Credit Update

Arizona

Credit rate tiers set to decrease for tax years ending on or after 12/31/2030:

<$2.5M Incremental QREs = 24% vs 20%

>$2.5M Incremental QREs = $600K + 15% vs $500K + 11%

Louisiana

Sunset date extended to 12/31/2025 (was 12/31/2021)

Maryland

Online application due no later than 11/15/2020

Funding cap applies (typically 10% - 11% of requested amount)

Approval certificate will be received by 2/15/2021

Because certificate comes after return is filed, taxpayers may either amend or utilize the credit in any of the 7 taxable years after the taxable year that generated the credit

Certificate must be attached to the return when utilized

This is helpful for taxpayers who do not want to amend

State R&D Tax Credit Update

New Jersey

Mandatory combined filing requirement

ASC allowed

Method used for federal and New Jersey must be consistent (i.e., if use ASC for federal it must be used for New Jersey)

North Dakota

For tax years 2019 and after, a taxpayer may elect to use the ASC method

Credit equals 17.5% of the first $100K incremental credits + 5.6% of the amount >$100K

$2M credit cap

Ohio

Increasing audit activity

Requirement to compute credit on calendar year basis (complexity for fiscal year taxpayers)

Texas

Increasing audit activity

Major focus on auditing on a project-by-project basis

Limited flexibility with respect to project documentation (i.e., must prove 100% of all R&D projects meet 4-part test, regardless of materiality)

Software, especially internal use software, continues to be an area of focus for exam

What’s New – Impact of TCJA

Travis Riley

Amortization of R&D Expenses

- Previous Law
  - Deduct R&D expenses immediately or charge to a capital account for no less than five years (IRC Section 174)
- TCJA
  - Starting in 2022, companies cannot immediately expense research costs under IRC §174. Instead, they’ll be required to charge US-based research expenses to a capital account and deduct them over a five-year period
  - Expenses incurred for research performed outside of the United States will be charged to a capital account and deducted over a 15-year period
- Impact
  - Value of credits could be reduced
  - Time value analysis should be performed
  - Intense lobbying to eliminate or prolong this provision is expected in the coming years

Value of R&D Credit Enhanced

- Previous Law
  - I.R.C. § 280C
  - A. Reduce expenses by amount of gross credit. Pay tax on increase to income
  - B. Elect a Reduced credit under I.R.C. §280C(c)(3)
- TCJA
  - Maximum tax rate decreased to 21%
  - Net credit equal to 79% of gross instead of 65%
- Impact
  - Lower Corporate Tax Rate Leads to Increased Credits
  - Net credit equal to 79% of gross instead of 65%
  - Additional 280C implications

Tax Rate	21%	35%
R&D Credit	$100,000	$100,000
280C(c)(3) Addback	($21,000)	($35,000)
Net Credit	$79,000	$65,000

Alternative Minimum Tax

- Previous Law
  - Corporate taxpayers – AMT @20%
  - Individuals - Nearly 60% of taxpayers making between $200k and $500k were hit with AMT
- TCJA
  - Corporate AMT Repealed
  - Individual exemptions and phase-outs increased (expires 12/31/2025)
  - ESBC Remains
  - 25/25 Limitation Remains
- Impact – Corporate and individual taxpayers can use more of their credits

Changes to Net Operating Loss Deduction

- Previous Law
  - NOLs – 2-year carryback / 20-year carry forward
- TCJA
  - NOLs limited to 80% of taxable income; carry forward indefinitely
  - Modified by CARES Act – limitation begins in 2021
  - Applies to NOLs generated in 2018 and beyond

Changes to Net Operating Loss Deduction (Continued)

Example

Taxable income before NOLs	$10,000,000
NOLs from 2018-2020	($8,000,000)
Taxable income	$2,000,000
Regular Tax @21%	$420,000
25/25 floor	$98,750
R&D credit usability	$321,250

Reduction in Orphan Drug Credit

- Previous Law
  - Credit on 50% of eligible Costs
  - No 280C(c) election allowed
- TCJA
  - Credit on 25% of eligible Costs
  - 280C(c) election allowed
- Impact
  - Value of orphan credits decreased, but still significant

International Considerations

- Base Erosion and Anti-Abuse Tax (BEAT)
  - Applies to large multinational enterprises with gross receipts over $500M
  - Starting in 2026, the BEAT calculation will require companies to add back R&D Tax Credits
- Global Intangible Low-Taxed Income (GILTI)

Summary: Key Takeaways

Previous legislation	TCJA
R&D expenses could be deducted immediately	Capitalize R&D expenses starting in tax year 2022
Value of credit reduced based on 35% corporate tax rate	Value of credit reduced based on 21% tax rate led to larger credits
Corporate and individual AMT limited amount of credit that could be used	Corporate AMT Repealed / individual provisions enhanced, leading to more credits being utilized
NOLs - 2-year carryback / 20-year carryforward	NOLs limited to 80% of taxable income starting in 2021. R&D credits can help fill the gap
Orphan credit at 50%	Orphan Credit at 25%

ASC 730

Dan Mennel & Cheryl Teifer

ASC 730 Recap

- Genesis of ASC 730
  – A brief overview of how we got here
– An overview of the Rules
  – Who is eligible
  – How does it apply
– Feedback from Taxpayers
  – Pros and Cons
– Transition into the latest guidance

ASC 730 directive overview

- Objective
  – Strategically reduce the deployment of resources related to the examination of research credit issues
  – Clarify the original directive and expectations, and address some of the implementation challenges experienced by field exam
- Implementation date
- The revised directive applies to LB&I taxpayers who choose to calculate their QREs using the requirements of the directive on original returns timely filed (including extensions) for tax periods ending on or after July 31, 2020

ASC 730 directive—implementation challenges

- Financial statement (FS) amount includes items other than pure ASC 730 expenditures such as:
  - ASC 350-40 and 350-50 costs GAAP Internal Use Software & Web Development costs
  - ASC 730-10-55-2 in FS R&D costs specifically excluded from ASC 730
  - Other non-ASC 730 expenses in FS R&D
- Difference in understanding as to what is included in ASC 730 R&D
- Materiality difference between financial statement audits and exam audits
- Interpretation of directive language that a safe harbor limits exam's scope

ASC 730 directive changes—directive language

- Clarified scope of exam
  - "Safe harbor" language removed
- Taxpayer eligibility
  - Taxpayer must use US GAAP to prepare their certified audited financial statements and prepare their tax return
- Exam guidance section
  - Clarification of audit steps
  - Elevated review process
  - Commissioner's discretion for eligibility expanded
- New documentation requirements
  - Clarified HR organization chart
  - Methodology/walkthrough
  - Internal controls

ASC 730 directive—Appendix C changes

BEFORE	AFTER	REASON FOR CHANGE
ASC 730 Financial Statement R&D	Financial Statement R&D	Financial Statement line item includes non-ASC 730 expenses
	Lines 1b: Subtract: All amounts related to U.S. entities that are not included in taxpayer's consolidated federal income tax return	Remove any amounts not included on the consolidated Federal Income Tax return
Line3; U.S. ASC 730 Financial Statement R&D	Line 2: U.S. Financial Statement R&D	At this point, Line 2 still includes non-ASC 730 expenses
	Line 3a: Subtract: Expenses for Software not for sale, lease, or otherwise marketed	Remove software development costs, typically ASC 350-40 (GAAP Internal Use Software) and ASC 350-50 (Website Development) not treated as ASC 730 expenses
	Line 3b: Subtract: Expenses identified under ASC 730-10-55-2 or other Non ASC 730 Expenditures	Remove costs not included in ASC 730 to arrive at the closest approximation to ASC 730
	Line 4: U.S. ASC 730 Financial Statement R&D	New starting point properly reflects ASC 730 Financial Statement R&D

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