Taking Advantage of Research and Development Tax Credits

  

Valerie Fedie

Partner, Wipfli LLP

Outline

- How businesses benefit from the research credit
- Research credit basics
- Expenses that qualify for the credit
- Examples of qualified activities
- Computation of the credit
- Utilization of the credit
- State credits
- Documenting qualified activities and qualified expenses
- Audit Concerns
- Final § 174 Treasury Regulations
- Proposed IUS Treasury Regulations

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How Businesses Benefit From the Research Credit

How Can the R&D Credit Benefit You?

- **Credits reduce tax liability dollar per dollar**
  - A $50,000 credit reduces cash outflow to IRS and/or state
  - Limitations apply (discussed later)
- **Rules are applicable for all open tax years**
  - Allows returns to be amended to claim credit even if not previously claimed
  - Special rules for companies with NOLs may allow you to go beyond the normal statute of limitations
    - Client Example:
      - Engaged to complete study for 6/30/2011 – 6/30/2014
      - Because of NOLs from prior years, able to complete a study starting with tax year 6/30/2008 and true-up NOLs and R&D credit to help reduce tax liability in the current and future years
- **Deductions currently reducing taxable income are identified as Qualified Research Expenditures (QREs)**
  - Not creating additional deductions

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How Can the R&D Credit Benefit Your Client?

- **Legislation retroactively reinstated the credit for 2014**
- **Credit has been in existence since 1981**
- **Is treated as a "temporary credit"**
  - Requires legislation to extend
  - Has only had two six-month windows without the credit (1995-1996)
- **Regulations revised in 2004, which eliminated the "Discovery Test"**
  - This made it clear that there was no requirement that you had to be developing knowledge beyond what has previously been developed
- **Final Regulations issued July 2014 regarding supply expenditures**
  - Applies retroactively to all tax years
- **Proposed Regulation issued January 2015 regarding Internal Use Software ("IUS")**
  - Applies from January 2015 forward

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Common Myths

- The credit applies only to large businesses.
  - False. There is no minimum amount of expense required to qualify for the credit.
- We are a custom manufacturer and do not develop our own products; therefore, our customers may qualify for the credit, but we do not.
  - False. The credit applies to both products and processes; often custom manufacturers are required to develop the processes that are capable of producing the part/product based on specifications provided by the customer.
- We do not have a time tracking system in place; therefore, there is no way to determine our costs.
  - False. The courts have ruled that a time tracking system is not required to claim the credit; rather, businesses must be able to connect employees' activities to the qualified projects.
- If we claim the credit, we will be audited.
  - False. The credit is one of many factors used to identify taxpayers for audit, but it is not the only factor.

Research Credit Basics

Does Your Company Incur R&D Expenses?

- We have found that many companies apply their own definition of research and development when determining the opportunity for the credit
- The tax rules can vary significantly from what someone may consider research and development
- Product development and product improvement activities can qualify
- Process development and process improvement activities can qualify
    - This includes activities required by contract manufacturers to develop a part that meets the customer's part print and/or specifications

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Tax Definition of R&D – The Four-Part Test

- New or improved business component
- Technological in nature
- Deductible under IRC Section § 174
- Process of experimentation
- Prior to the change in the regulations at the end of 2003, the Discovery Test applied
  - Discovery Test required the development of technology beyond the common knowledge of those in the field

New or Improved Business Component

- **Activities must relate to the development of a new or improved business component:**

Product	Technique
Process	Computer software
Formula	Invention

  - Includes the improvement of an existing product or process related to:
    - Function
    - Performance
    - Reliability
    - Quality

- **Activities relating to style, taste, cosmetic, or seasonal design factors do not qualify**
  - Exceptions apply

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Technological in Nature

- Process of experimentation must rely on principles of:
  - Physical or biological sciences
  - Engineering
  - Computer science

- Research based on economic principles do not qualify
  - Can be part of qualifying research

- Employment of or reliance on computers and information technology does not of itself establish qualified research

Deductible Under Section § 174 (Uncertainty)

- Discover information that is not available to the taxpayer; and
- Eliminate uncertainty about the capability or method of developing or improving the business component or its appropriate design
- Patent safe harbor – Applies only to this test
  - If you have a patent, then you are deemed to meet the uncertainty requirement
- Does not require that there is an uncertainty in the taxpayer's ultimate ability to develop the product or process

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Process of Experimentation

- Core elements
  - Identify uncertainty
  - Identify one or more alternatives to eliminate uncertainty
  - Identify and conduct processes to evaluate alternatives
    - Modeling
    - Simulation
    - Systematic trial and error
  - “Substantially all” activities must constitute elements of the process
    - At least 80% of time must be incurred in “qualified activities”

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Funded Research

- Research funded by another person is not eligible for the credit
  - Review of contract is required
    - Fixed fee – Qualified
    - Time and materials – Nonqualified
    - Not to exceed – Qualified
- Certain related-party payments not considered funding
- Fully funded if the taxpayer retains no substantial rights

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Controlled Groups

- Members of controlled groups are treated as one taxpayer
- ALL R&D credit rules apply on a controlled group basis
- 50% or 80% common ownership
  - 50% – C corporations
  - 80% – Partnerships, S corporations, and mix of C corporations with Partnerships and/or S corporations
- Combined credit is allocated to separate companies
  - Recent legislation has revised the allocation method
  - Credit is now allocated based on each separate company's ratio or QREs to total QREs

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Acquisitions and Dispositions

- Special rules for calculating credit when major portion of trade or business changes ownership
- Gross receipts and QRE history is transferred to the buyer
- If an asset acquisition occurs and the active operations are acquired, these rules apply, and the base period information transfers to the new entity even though a new legal entity is formed
- Recent legislation has added a provision for the year of occurrence to include/exclude for only the number of days in the tax year

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Internal Use Software

The Tax Reform Act of 1986 stated additional criteria must be applied to Internal-Use Software (“IUS”) development for such activity to qualify for the tax credit.

1) Be Innovative
   - Innovative software = unique/novel and different in significant and inventive ways (Disguised discovery test)
2) Involve Significant Economic Risk
   - Substantial resources are committed to the development and there is substantial uncertainty, because of technological risk, that the resources will be recovered within a reasonable period of time.
3) Be Commercially Unavailable
   - Not commercially available without significant modifications or enhancements

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Five Exceptions – Internal-Use Software

- Developed for use in an activity that constitutes qualified research
- Developed for use in providing computer services to customers
    - The customer conducts business with the taxpayer primarily for use of its computer or software technology, not merely because customer interacts with the software.
- Developed for use in a production process
- New or improved package of software and hardware developed together as a single product, of which the software is an integral part, that is used directly by the taxpayer in its trade or business
- Licensed or Sold

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Specifically Excluded Activities

- Research (including contract research) conducted outside the United States, Puerto Rico, or other U.S. possessions
- Research after commercial production: Exception: may still qualify if related to process improvements
- Research where Taxpayer does not retain substantial rights (Funded research)
- Research related to management functions or techniques, surveys, routine collection of data
- Market Research
- Adaptation of an existing product to a particular customer's requirement or need, without any uncertainty present
- Reverse engineering
- Research relating to style, taste, cosmetics, or seasonal design factors
- Routine testing, quality control, or maintenance
  - Testing or inspection to determine whether particular units of materials or products conform to specified parameters is non-qualified activity (quality control).
  - Testing to determine if the design of a product or process is appropriate may be qualified activity (quality assurance).

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Qualified Research Expenditures

Qualified Research Expenditures

- Qualified wages
  - Direct research
  - Direct supervision
  - Direct support
- Contract research expenses
- Supplies
- Computer lease time

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Qualified Wages

- Direct research
- Direct supervision
  - Only first-line supervisors
- Direct support
  - Direct support activities do not need to meet the four-part test
  - Administrative time for typing reports
  - Person who cleans laboratory equipment used in qualified research
  - Machinist who machines a part for an experimental model

Qualified Wages

- Eligible Compensation
  - Income subject to withholding per IRC Section 3401(a)
    - W2 taxable wages from box 1
  - Incentive bonuses
- Ineligible Compensation
  - Non-taxable fringe benefits
  - Employer's share of payroll taxes
  - Travel costs not included in compensation
- Allocation of wages between qualified and non-qualified activities
  - 80% Rule
  - Formula includes only actual time spent working (excludes vacation, holiday, sick time, and other paid time off)

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Contract Research Expenses

- 65% of qualified amounts paid or incurred are included
- Must be an activity that would have qualified if performed by an employee
- Must meet two tests:
  - “On behalf of” – Rights in technology
  - Economic risk – Who bears financial risk for the research
- International Contract Research is eligible for IRC § 174 deduction, but not available for IRC § 41 credit.

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Supplies

- Tangible personal property
  - Not land or depreciable property
  - Must be used in the research activity
  - Extraordinary utilities
    - Must demonstrate special character of research and requires:
      - Process uses a large amount of utilities
      - Utilities related to machinery would not qualify
- Final Regulations – Expand opportunity to include all supplies used in the conducted of research prior to uncertainty being eliminated
- TG Missouri
  - Plastic injection molder
    - Costs paid to outside tool house qualified as supplies

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Examples of Qualified Activities

Examples of Qualified Activities - Manufacturing

- Improvements or building of new manufacturing facilities
- Implementation of new technologies to the manufacturing floor
- Development of specialized machinery and modifications to existing equipment
- Improvements made to a production process or to the materials used in a manufacturing process, intended to result in lower environmental contaminants
- Improvements to processes to lessen emissions of various gases
- Manufacturing efforts that support new product development
- Performance of certification testing
- Attempt to use new materials
- Scaling up formulations from test facility to production facility

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Examples of Qualified Activities - Manufacturing

- Development of new, improved, or more reliable products
- Development or improvement of manufacturing processes
- Automated processes
- Development of prototypes
- Design and/or build of tools, jigs, fixtures, dies, and molds
- Development of or application for patents
- Continuous improvement activities focused on manufacturing processes
- Conducting testing of new concepts and technology
- Development of new technology
- Development of software
- Design of products to customer specifications

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Examples of Qualified Activities - Software

- Co-development efforts with an outside vendor;
- Major system re-architectures;
- Systems developed from scratch after determining that no commercial solution existed;
- Projects to develop functionality unique and new to the industry;
- Use of new technology or even existing technology in a new and unique way;
- Development of a unique security schema;
- Integration efforts to merge many discrete systems into one system;
- Development of new middleware
- Creation of a new or unique architecture (i.e., layered architecture);

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Examples of Qualified Activities – Software

- Development of a new software methodology for rapidly developing or deploying software;
- Creation of unique algorithms or rules engines to accomplish a task;
- Development of a unique clustering, load balancing or failover schema;
- Efforts to extend or enhance the capabilities of a commercial software product;
- Software that results in providing the company with a competitive advantage.

Computing the Credit

Traditional Method

- Federal credit of 20% of the lesser of:
  - The qualifying expenditures in excess of a base amount, or
  - One-half of the qualifying expenditures
  - Credit is added to income
- Reduced credit is 13%
  - Credit is not added to income

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Determination of Base Amount

- Fixed base percentage
  - Ratio of R&D expenditures to gross receipts from 1984–1988
  - Maximum of 16%
- Base amount
  - Average annual gross receipts for prior four tax years times the fixed base percentage
- Start-up rules apply to companies that had no R&D costs during 1984-1988 time period
  - 3% for first 5 years, phase in calculation 6-10 years

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Gross Receipts

- Gross receipts from all sources are included,

Except gross receipts do not include:

  - Returns and allowances
  - Receipts from the sale or exchange of capital assets
  - Repayments of loans
  - Receipts from a sale or exchange not in the ordinary course of business
  - Sales tax collected and remitted

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Example Calculation #1

- AAGR-$25,000,000
- C/Y QREs-$1,400,000
- Base period percentage-1%
- AAGR x base period percentage of $25,000,000 x 1% = $250,000

Total QRE =	$1,400,000
Base =	$ 250,000
Eligible =	$1,150,000
Limited to =	$ 700,000
Credit rate =	20%
Credit =	$ 140,000

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Example Calculation #2

- AAGR-$25,000,000
- C/Y QREs-$1,400,000
- Base period percentage-5.5%
- AAGR x base period percentage of $25,000,000 x 5.5% = $1,375,000

Total QRE =	$1,400,000
Base =	$1,375,000
Eligible =	$ 25,000
Credit rate =	20%
Credit =	$ 5,000

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Example Calculation #3

- AAGR-$5,000,000
- C/Y QREs-$400,000
- Base period percentage-2%
- AAGR x base period percentage of $5,000,000 x 2% = $100,000

Total QRE =	$400,000
Base =	$100,000
Eligible =	$300,000
Capped =	$200,000
Credit rate =	20%
Credit =	$ 40,000

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Alternative Simplified Credit

- Benefits companies with high fixed base percentage, companies that have not increased research activities over time or where computation of the base period is impossible
- Enacted 1/1/07
- Threshold = Half the average QREs for prior three years
- Credit rate of 14%
- If no QREs in any one of the prior three years, credit rate of 6% of current-year QREs
- Is treated as an election
  - Can be claimed on a currently filed return (including extensions)
  - New Treasury Regulation T.D. 9666 – ASC can be used on amended returns.
  - Can change from ASC to traditional from one tax year to another

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Example #1

- QREs
  - 2011 - $1,250,000
  - 2012 - $1,300,000
  - 2013 - $1,350,000
  - 2014 - $1,400,000

2014 QRE =	$1,400,000
Base =	$650,000
Eligible =	$750,000
Credit rate =	14%
Credit =	$105,000

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Example #2

- QREs
  - 2011 - $400,000
  - 2012 - $400,000
  - 2013 - $400,000
  - 2014 - $400,000

2014 QRE = $400,000

Base = $200,000

Eligible = $200,000

Credit rate = 14%

Credit = $28,000

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Example #3

- QREs
  - 2011 - $0
  - 2012 - $0
  - 2013 - $150,000
  - 2014 - $350,000

2014 QRE = $350,000

Credit rate = 6%

Credit = $21,000

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Utilization of the Credit

Utilization of the R&D Credit

- R&D credit offsets the tax liability dollar for dollar
- Credit can reduce the tax liability only to the amount of the Tentative Minimum Tax
- R&D credit passes through to the owners of pass-through entities
  - Credit is limited to tax related to income from the entity that generated the credit – Section 41(g)
  - Section 41(g) limitation opportunity – Credits in excess of tax liability limit have a special carryover rule; no TMT limitation applies
  - If the owner is passive, the R&D expenditures are an AMT adjustment

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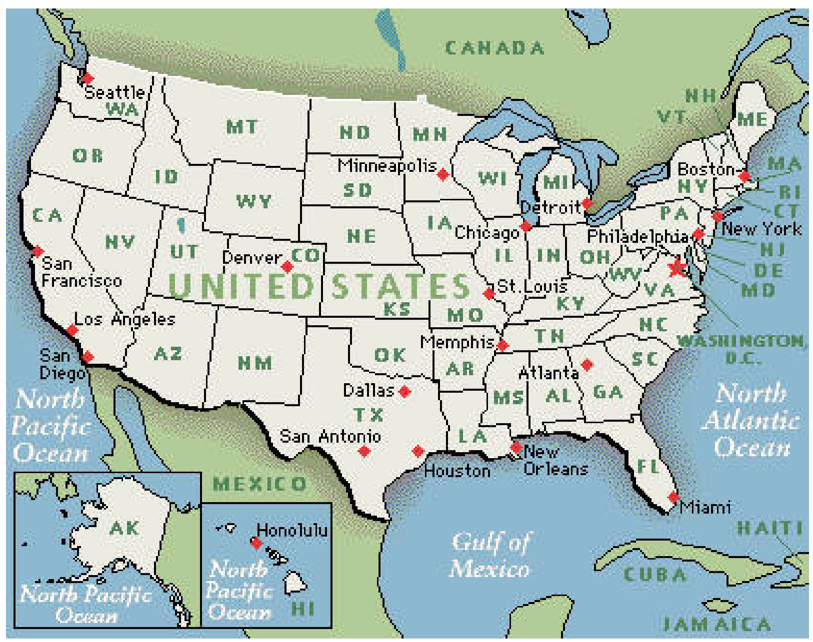
Utilization of the R&D Credit

- Credit is generally limited to reduce tax to a maximum of 75% of the total tax
- Excess credits
  - Carried back one year – Mandatory
  - Remaining amount is carried forward 20 years
  - Opportunity exists for companies that have been in a loss situation
    - Revenue ruling allows for the adjustment of carryovers from an otherwise closed tax year
    - Can adjust an NOL and research credit carryover without amended tax returns

State Credits

State Credits

- Most states have some type of R&D incentive
- States typically follow federal rules in regards to which activities qualify for the credit
- Some states limit the credit to certain types of entities



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State Credits – Examples of Variation

- Some states provide for a refund or exchange of the credit so that even if a taxpayer has no tax liability it can still benefit.
- R&D statutes of most states have expiration provisions that differ from the federal statute.
- Most states allow a credit only for research performed in the state, but some allow it for research apportioned to the state regardless of where the activities occurred.
- Some states use the federal definition of qualified research and others modify it to either expand or restrict the activities that qualify.

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State Credits – Examples of Variation

- Some states do not allow the use of alternative credit calculations, such as ASC.
- In some states, a research credit is provided for basic research payments; in others, not.
- Some states offer a refundable credit (Minnesota).
- Some states allow taxpayers to apply the credit to totally eliminate the tax liability in a given year.
- Some sates provide some restriction on use of the research credit, usually limiting to some percentage of tax liability.

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State Credits – Examples of Variation

- Most states allow the credits to be carried forward to future years (range from 3 years to 20 years).
- Only a few states allow the credit to be carried back to prior years.
- Most states calculation is incremental, similar to the federal credit.
- Some states offer a modified base amount calculation (prior three or four years verses traditional base period calculation).
- Some states have allowed an election to use the AIRC method

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State Credits – Examples of Variation

- If a State does allow the AIRC method, the federal election controls which method the state must also use.
- In some states, the federal calculation election has no effect on the state calculation election.
- Some states, like Utah, IRC Code Sec. 174 R&D deduction is increased by the amount that had been disallowed under IRC Code Sec. 280C(c).

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State Credits – State Tax Structures

- States generally offer incentive packages that include multiple incentives for research activities, including:
  - Investment credits
  - Job credits
  - Sales tax exemptions
  - Property tax abatements
  - Training Credits
  - Enterprise Zone Benefits
  - Tax credits for venture capital investments
  - Tax credits for the transfer of technology from Universities

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State Credits – State Tax Structures

- It is important to analyze factors such as:
  - The amount and types of income subject to tax
  - The applicable tax rate
  - Whether income of related companies would be taxed
  - Whether payments made to related companies are deductible
  - States apportionment method
    - Throwback Sales method
  - Combined Returns for Unitary Businesses
- Deductibility of R&D Expenditures
  - All States except for Arkansas adopts IRC Code Sec. 174 and allows companies to deduct R&D expenditures

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Minnesota R&D Credit

Traditional Research Credit

- C corporations, S corporations and partnerships are eligible to claim the credit. Note: change to allow S corps to qualify.
- 10% of the first $2,000,000 of the excess (if any) of the QRE for the taxable year in excess of the base amount and 2.5% on all such expenses over $2,000,000 for QREs incurred in MN
- Base amount: same as federal but based on MN gross receipts and MN expenses
- Refundable Credit for Tax Years 1/1/2010 – 12/31/2012
- Tax Years 2013 – Forward, excess credit carried forward for 15 years

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Minnesota R&D Credit

Tax Year Ended	12/31/2010
MINNESOTA	
Wages	650,000
Supplies	25,000
Contract Research @ 65%	10,000
Total Minnesota QRE	**685,000**
Fixed Base %	3.00%
Average Annual Gross Receipts	10,000,000
Calculated	300,000
50% Limitation	342,500
Base Amount	342,500
Calculated Base Amount	342,500
Reduction in Applicable Base	342,500
Applicable Base Amount	-
Calculated 1) Reduction * 10%	34,250
Calculated 2) Base * 2.5%	-
MINNESOTA Allowable Credit	**34,250**

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Wisconsin Credits

- Wisconsin follows the same rules as federal, except:
  - Sales in both the base period and AAGR include only sales shipped to Wisconsin customers
  - Only qualified expenditures incurred in Wisconsin qualify
- Two calculation methods: traditional and AIRC
- Excess credits carried over for 15 years

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Documentation Requirements

Documentation Requirements

- No specific documentation requirement exists in the code or regulations
- Must retain records in "sufficiently usable form and detail to substantiate that expenditures are eligible for the credit"
- Failure to keep records in any particular manner cannot serve as a basis for denying the credit
- Case law supports the use of estimates when underlying documentation supports those estimates
- Records must do the following:
  - Prove or help to prove the projects qualify
  - Connect the employees involved directly or indirectly to the project

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Documentation Requirements

- What is needed upon audit
  - Identification of employees involved
  - Why projects qualify for credit
  - Allocation of costs to projects

- Records must provide a connection between the employees, the projects, and why the projects qualify
  - "Oral Testimony" – IRS and states have taken the position that an explanation of why a project is qualified is not sufficient. An explanation can be included (is typically necessary to explain the Four-Part Test) but must be supported by documentation to corroborate what has been explained

- Taxpayers are allowed to prepare documentation after the fact and claim the credit

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Documentation Requirements

- Examples of records that can help support qualified activities have occurred
  - Project charter/approval
  - Purchase order; demonstrates what a customer wants developed
  - Initial concept designs
  - Design review meeting notes
  - E-mails discussing design issues
  - Test data; this is crucial
  - E-mails discussing test data/design changes because of test data
  - Design revisions
  - Final design
  - Design approval meeting

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Audit Concens

Audit Risks

- Currently filed returns
- Amended tax returns
- States
  - Minnesota
    - Audit refundable credit
  - Wisconsin
    - Sales and use tax issue on research expenses and equipment used in research

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Audit Risks

- Do not let the IRS/state drive the audit
  - They will ask for records on every project
  - In most cases, this will not be necessary because a sample can be used as a starting point to evaluate the basis of the expenses claimed
- Do not be afraid to disagree with the auditor's position
- Do not be afraid of the appeals process
  - IRS bifurcates a claim between base period issues and current-year issues
- States: California, Minnesota, and Wisconsin are aggressive; however, do not be afraid to claim the credit; you should be allowed what you deserve based on tax law, no more and no less

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Final § 174 Treasury Regulations – T.D. 9680

IRC § 174 Expenditures

- IRC § 174 Expenditures
  - Defines what is a research or experimental expenditure
  - Allows taxpayers the option to currently deduct research or experimental expenditures or to treat as deferred expenses and amortize these costs over a period of no less than 60 months
  - The election to capitalize costs requires a signed, written election
  - The election can be specific to a particular project or a general election to apply to all projects
  - The election can be revoked by filing Form 3115, Application for Change in Accounting Method
  - This is a significant positive change for taxpayers

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Final § 174 Treasury Regulations

- Issued July 18, 2014 (T.D. 9680)

- IRS position in court cases - § 174(c) precludes § 174 treatment in the case of a subsequent sale of a resulting product to a customer, because the sales give rise to depreciable property in the hands of the customer.
- Taxpayer position in court cases
  - TG Missouri – expenses related to tooling sold to customer are eligible as supplies as the tool is not a depreciable asset to TG Missouri

- Preamble to Regulations
  - The IRS and Treasury Department believe that an interpretation of the Depreciable Property Rule that creates an override to § 174 eligibility upon the occurrence of a subsequent event does not further Congressional purpose of resolving accounting uncertainties and encouraging business investment in research because taxpayers may not be able to know whether an expenditure was § 174 eligible at the time the expense is paid or incurred.

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Final § 174 Treasury Regulations

- Five Major Changes

1. Provides that if expenditures qualify as research or experimental expenditures, it is irrelevant whether a resulting product is ultimately sold or used in the taxpayer's trade or business.
2. The Depreciable Property Rule contained in § 1.174-2(b)(4) is an application of the general definition of research and experimental expenditures contained in § 1.174-2(a)(1) to depreciable property.
3. Define the term "pilot model."
4. Clarify the general rule that the costs of producing a product after uncertainty is eliminated are not eligible for research or experimentation.
5. Provides for a "shrinking-back" provision, similar to that found in § 41.

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Planning Opportunities

- Section 174 cost or start-up expenditure?
  - We have had several instances with new clients where the prior firm claimed Section 174 costs as start-up expenditures
    - Start-up expenditures are amortized over 180 months, and no election is required
    - Section 174 costs can be deducted currently and require a written, signed, and timely prepared election
  - Amend return to claim Section 174 costs
  - As favorable depreciation rules change, identifying 174 costs will potentially be more favorable to taxpayers
- Benefit in addition to qualifying for the credit: If a cost can be classified as a Sec. 174 research expense, the cost does not need to be treated as a capital asset and is also not subject to the Sec. 263A rules
  - This converts the cost to a currently deductible expense

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Supplies: New Regulations

- Examples provided by the IRS
  - U produces custom machines based on customer specifications
  - U contracts with a customer to produce a machine that has different specifications from what it has previously produced
  - U incurs $31,000 of costs on the project
    - $10,000 of costs relate to materials and labor to produce a model that is used to evaluate and resolve the uncertainty concerning the appropriate design
    - U also incurs $1,000 of costs using the model to test whether certain features can be integrated into the design of the machine
    - After uncertainty is eliminated, U incurs $20,000 of production costs
  - $11,000 of the costs are treated as research expenses

Supplies: New Regulations

- Examples provided by the IRS:
  - Same facts as previous example, except during a quality control test of the machine, a component of the machine fails to function because of the component's inappropriate design
  - U incurs an additional $8,000 to reconfigure the component's design, which is classified as research and development cost in the experimental or laboratory sense
  - After the elimination of uncertainty regarding the appropriate design of the component, U incurs an additional $2,000 on its production
  - In addition to the $11,000 originally incurred, which qualified as a research expense, the additional $8,000 would also qualify as a research expense

Supplies: New Regulations

- Examples provided by the IRS:
  - V is a manufacturer that designs a new product; V incurs $5,000 to produce a number of models of the product that are to be used in testing the appropriate design before the product is mass-produced for sale
  - The $5,000 of costs represents research and development costs in the experimental or laboratory sense
  - Multiple models are required to test the design in a variety of different environments
  - Not all models were ultimately used in testing; however, because V produced the models to resolve uncertainty regarding the appropriate design of the product, the models are pilot models and thereby a research expense

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Supplies: New Regulations

- Examples provided by the IRS:
  - W wants to improve a machine for use in its trade or business and incurs $20,000 to develop a new component for the machine
  - The $20,000 is incurred for engineering labor and materials to produce a model of the new component that is used to eliminate uncertainty regarding the development of the new component for the machine
  - The $20,000 of costs represents research and experimental costs in the experimental or laboratory sense
  - After W completes its research and experimentation on the new component, it incurs $10,000 for materials and labor to produce the component and incorporate it into the machine

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Supplies: New Regulations

- Examples provided by the IRS:
  - 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 represents research and development costs in the experimental or laboratory sense
  - In a later year, X sells the aircraft
  - The $5,000,000 of costs qualify as a research expense

Supplies: New Regulations

- Examples provided by the IRS:
  - Y is a manufacturer of aircraft engines and is researching and developing a new type of compressor blade, a component of an aircraft engine, to improve the performance on an existing engine that it already manufacturers and sells
  - To test the appropriate design of the new compressor blade and evaluate the impact of fatigue on the compressor blade design, Y produces and installs the compressor blade on an aircraft engine from its inventory
  - The costs of producing and installing the compressor blade qualify as a research expense
  - The cost of the engine does not qualify

Supplies: New Regulations

- Examples provided by the IRS:
  - T is a fuselage manufacturer for commercial and military aircraft and is modifying one of its existing fuselage products to enable it to carry a larger passenger troop and cargo load
  - T incurs $1,000,000 to develop and evaluate different designs to resolve uncertainty with respect to the appropriate design of the new fuselage class
  - The $1,000,000 represents research and development costs in the experimental or laboratory sense
  - Although this is a variant of an existing model, this is a new product, and because the development of the first model does not resolve the uncertainty of the second model, the project qualifies as a research expense

Supplies: New Regulations

- Examples provided by the IRS:
  - Z is a wine producer and is researching a new wine production process that involves the use of a different method of crushing the wine grapes
  - In order to test the effectiveness of the new method of crushing wine grapes, Z incurs $2,000 in labor and materials to conduct the test on this part of the new manufacturing process
  - The $2,000 of costs represents research and development costs in the experimental or laboratory sense
  - The $2,000 incurred qualifies as research or experimental expenses

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Supplies: New Regulations

- Examples provided by the IRS:
  - X is a tool manufacturer and has developed a new tool design and orders a specially built machine from Y to produce X's new tool
  - The machine is built on X's order and at X's risk, Y does not provide a guarantee of economic utility, and there is uncertainty regarding the appropriate design of the machine
  - Under X's contract with Y, X pays $15,000 for Y's engineering and design labor and $5,000 for materials and supplies used to develop the appropriate design of the machine for research or experimentation under Sec. 174
  - X pays Y $10,000 of production costs after the appropriate design of the machine is developed
  - The $20,000 qualifies as a research expense
  - The $10,000 does not qualify as a research expense and is a capital asset

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Supplies: New Regulations

- Examples provided by the IRS:
  - Z is an aircraft manufacturer and incurs $5,000,000 to construct a test bed that will be used in the development and improvement of a new aircraft
  - No portion of the $5,000,000 for the test bed represents research and development costs in the experimental or laboratory sense to develop or improve the test bed
  - The $5,000,000 will not be treated as a research expense and is required to be capitalized and depreciated

Supplies: New Regulations

- Examples provided by the IRS:
  - Same facts as previous example, except $50,000 of the $5,000,000 of the costs of the test bed relates to research and development costs in the experimental or laboratory sense
  - The $50,000 of costs will qualify as a research expense
  - The remaining $4,450,000 will be treated as a capital asset and depreciated

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IUS Treasury Regulations (REG-153656-03)

IUS Treasury Regulation – Proposed 1/16/2015

- Preamble to regulations note that "today, computer software is used in all aspects of business activity, especially in providing goods and services to third parties, and such software has played a vital role in increasing the productivity of the U.S. economy and in making the U.S. more competitive globally."

- Third-party-facing software therefore is considered to be non-IUS software and therefore only needs to satisfy the regular 4-part test under IRC 41(d)(1) to qualify for the credit.

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IUS Treasury Regulation – Proposed 1/16/2015

- Distinguishing IUS from non-IUS
- “Back-Office” functions that most taxpayers would have regardless of industry
- Includes General and Administrative Functions:
  - Financial management functions
  - Human Resource management functions
  - Support service functions
- Safe Harbor – For cases in which it is not possible to isolate the third-party subset, the new “dual-function” software rules apply.

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IUS Treasury Regulation – Proposed 1/16/2015

- Proposed IUS Regulations – Align with internet-driven world
- Software is not developed primarily for internal use if either:
  - The software is developed to be commercially sold, leased, licensed, or otherwise marketed to third parties; or
  - The software is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system

IUS Treasury Regulation – Proposed 1/16/2015

- Examples in Preamble of software that is treated as not primarily for internal-use under “new” rules (which was unclear under “old” rules):
  - Enable third parties to execute banking transactions
  - Track the progress of a delivery of goods
  - Search a taxpayer’s inventory for goods
  - Purchase tickets or make reservations
  - Receive services over the internet
  - Store and retrieve a third party’s digital files

IUS Treasury Regulation – Proposed 1/16/2015

Opportunities

- Impacts a wide range of industries that use software to deliver products and services, including:
  - Banking
  - Insurance
  - Telecommunications
  - Retail
  - Manufacturing
  - E-Commerce
- State/Local research tax incentives (e.g., credits, sales-use tax exemptions, etc.

Questions?

Contact Us

Valerie Fedie
Partner, St. Paul Office
651.556.2235
vfedie@wipfli.com

Kendra Goodman
Manager, St. Paul Office
651.556.2236
kgoodman@wipfli.com

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Additional Resources

Visit the R&D Tax Page on Wipfli's website:

http://www.wipfli.com/Service_Tax_Research_Development_Tax_Credit.aspx

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