Taking Advantage of Research and Development Tax Credits

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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
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
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
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.
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
  - Process
  - Formula
  - Technique
  - Computer software
  - 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
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
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”
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
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
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
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
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
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).
Qualified Research Expenditures
Qualified Research Expenditures

- Qualified wages
  - Direct research
  - Direct supervision
  - Direct support
- Contract research expenses
- Supplies
- Computer lease time
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)
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.
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
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
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
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);
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
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
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
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
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
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**
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
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
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
Example #3

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

2014 QRE = $350,000

Credit rate = 6%

Credit = $21,000
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
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
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.
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 states provide some restriction on use of the research credit, usually limiting to some percentage of tax liability.
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.
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).
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
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
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
# Minnesota R&D Credit

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<td>Supplies</td>
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<td>Contract Research @ 65%</td>
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<td><strong>MINNESOTA Allowable Credit</strong></td>
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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
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
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
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
Audit Concerns
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
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
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
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.
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.
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
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
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.
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.
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.
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.
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.
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
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.
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.
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
IUS Treasury Regulations (REG-153656-03)
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.
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.
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
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
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?
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