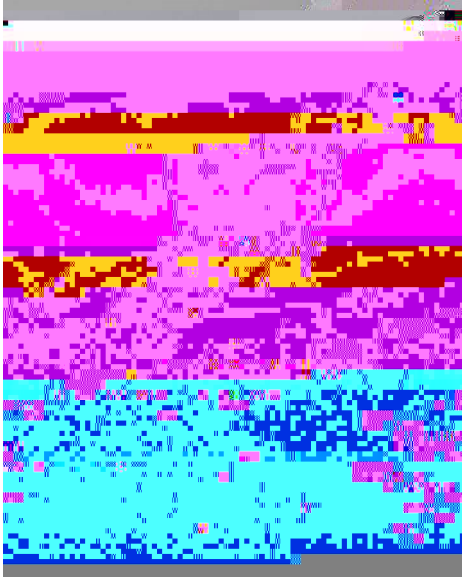




Paul F. Coates is a Senior Revenue Agent in General Business Credit Enterprise Practice Area of Large Business and International (LB&I). In this role, Paul serves as subject matter expert for certain business credit and deduction tax incentives, including the credit for increasing research activities and research or experimental expenditures. The General Business Credit Practice Area provides assistance to identify, develop and present tax issues in direct examinations. The Practice Area also assists to implement compliance and training strategies, corporate tax legislation and regulation and guidance projects throughout LB&I and the IRS. Prior to this role, Paul served as section 174 and section 41 technical advisor in the Issue Practice Group, the predecessor unit of General Business Practice Area.

Tony Coughlan



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- RSM Washington National Tax R&D Leader
- Publications in the field of R&D:
 - *An Early 21st Century History of IRS Efforts to Police the Research Credit* (co-author), THE TAX ADVISER (April 2022)
 - *Biden's Proposal to Swap FDII for R&E Expenditure Support*, 103 TAX NOTES INT'L 10 (Sept. 20, 2021)
 - *Research Credit Election Considerations*, 164 TAX NOTES FED'L 193 (Jul. 8, 2019)
 - *Section 174 R&E Deduction Upon Statutory Stock Option Exercise*, 58 TAX LAW. 435 (2005)
 - *R&D Credit Regulations Considered* (co-author), 2003 TAX NOTES TODAY 213-23.
- Senior Tax Counsel, Senate Finance Committee (2009-18):
 - Lead for R&D tax incentives, international tax
 - Significant involvement with drafting of TCJA
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 - Georgetown University Law Center, LLM (Tax), *with distinction*
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Keith has nearly 25 years of public accounting experience with a focus on the R&D tax credit and accounting methods technical areas. He has worked across a large variety of industries, including technology, life sciences, media and entertainment, and aerospace and defense. He specializes in IRS exam controversy and has worked with Fortune 500 and middle-market companies.

Prior to joining Grant Thornton, Keith was a partner in the Specialized Tax Services group and leader of the Life Sciences R&D credit practice at PricewaterhouseCoopers LLP, where he led and managed the pursuit and delivery of tax services related to the

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New Section 174 R&E Capitalization



Software Development Costs under Revenue Procedure 2000-50

- Rev. Proc. 2000-50 provides guidelines on the treatment of computer software costs (presumably its applicability will be modified for tax years beginning after December 31, 2021).
- Computer software is defined as “any program or routine (that is, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine”
- Rev. Proc. 2000-

Possible Approaches to Estimate SRE

R&E and SRE Paid Or Incurred Under Contractual Arrangements

- Do R&E expenditures paid or incurred by a service provider under contract on behalf of and at the economic risk of a customer fall within the definitional scope of section 174?
- Economic risk is borne by a customer where payment is not contingent on the success of research (e.g. “time and materials” or “cost plus” contracts).
- Some commentators suggest that additional guidance is needed to address whether costs paid or incurred under contractual arrangements are SRE.
- The section 174 regulations address the issue of research performed under contract only from the perspective of the customer or service recipient (i.e. the *payor*):
 - Expenditures paid or incurred for research carried on in taxpayer’s behalf by another person or organization (i.e., payor’s behalf) are R&E expenditures ***only if*** the research is undertaken upon the taxpayer’s order and at the taxpayer’s risk (Treas. Reg. § 1.174-2(b)(3)).
 - Does this provision *imply* that a taxpayer acting as a research service provider must also be “at risk” to treat costs as R&E expenditures? The answer is not clear.

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Section 41 Funded Research

- Does the exclusion of “funded research” from research credit eligibility imply that section 174 does not already contain such an exclusion? The answer is not clear.
 - Section 41(d)(1) defines qualified research (in part) as expenditures that may be treated as specified research or experimental expenditures under section 174.
 - Section 41(d)(4)(H) also excludes “Funded Research” from the definition of qualified research.
 - The

- 
- Guidance to Conform to Statutory Method for Treatment of SRE

Current state v. future state

Post-2021

- Significant changes to the treatment of R&E expenditures in 2022 as a result of Tax Cuts and Jobs Act (TCJA)
 - *Required* capitalization and amortization
 - Domestic – 5 years (SL, Mid point)
 - Foreign – 15 years (SL, Mid-Point)
- Software development costs are defined as section 174 expenditures.
- The deductions are not accelerated even if the property is sold or abandoned.

Minimize R&E Subject to Capitalization?

- Would the expenditure otherwise be deductible under Section 162?
 - Rights & Risk analysis
 - Section 482-7 and other related and unrelated contractual arrangements
- If you successfully argue that a given expenditure is NOT a R&E expenditure under section 174, are you sure it is deductible under section 162?
- Would this harm the Section 41 Research Credit claim?
- Will this harm 1.861-17 R&E apportionment and FTC planning? FDII implications?

- IRS issued October 15, 2021 Chief Counsel Memorandum 20214101F, January 3,

Issues and Concerns

- Does this impact only refund claims? Or all claims?
- Is this consistent with Rev. Proc. 2011-42 Statistical Sampling?
- Can taxpayers challenge a refund claim that the IRS finds deficient?

- Many have criticized the IRS for its informal implementation of the changes.
 - ABA, AICPA, and National Association of Manufacturers have each sent letters requesting clarification or delay of implementation.

R&D and Specificity – A Brief Look Back & Update

Feb 8 – 3 Additional FAQs

- BBA partnerships: BBA partnerships do not file an amended return, but rather file an Administrative Adjustment Request (AAR), with the five items of information. The BBA partners, however, do not need to provide the five items of information with their amended tax return with the attached Form 8986.
- Non-BBA pass-throughs: TEFRA partnerships, S corporations and other non-BBA pass-throughs, however, “may” include the five items of information with their amended return. The partners or S corporation shareholders, however, “are required to include the five items of information with their amended tax return claiming the Research Credit.”
- Appeals: According to the FAQ update, “the Appeals resolution process is not available for refund claims that are rejected on the basis that they are deficient.” In this case the IRS will issue a no consideration letter. No consideration letters will not be appealable to the IRS Independent Office of Appeals. The taxpayers will also not be able to bring a refund suit in the appropriate district court or federal court of claims.

...

Speaking of Specificity ...

- Where do Form 6765 amendments stand?

280C(c) Background

Research Credit Claimants have had a choice:

- EITHER claim a full/gross \$100 credit, *and* lose \$100 of deductions
- OR – claim a 20% credit *and* lose 80% of deductions

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280C(c) Background (cont'd)

Pre-TCJA: Research Credit Claimants that could almost always made a 280C(c) election for a reduced credit

2018-2021: Most taxpayers usually still made a 280C(c) election, but not always ...

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Section 280C(c)(1) 'Conforming Changes'

I.R.C. § 280C(c)(1) In General —

If—

(A) — the amount of the credit determined for the taxable year under section 41(a)(1), exceeds

(B) — the amount allowable as a deduction for such taxable year for qualified research expenses or basic research expenses,

the amount chargeable to capital account for the taxable year for such expenses shall be reduced by the amount of such excess.

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Illustration of the new 280C(c)

Assume in 2022:

- o QREs = \$1,000
- o (Gross) c(r)(l i)6o40608 6 >>B86

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Illustration of the new 280C(c) (cont'd)

Assume in 2022:

– QREs = \$1,000

–

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Illustration of the new 280C(c) (cont'd)

NO, the credit equals the deduction, thus 280C(c)(1) does nothing.

And will usually do nothing.

Thus, the question becomes: Would you prefer a \$100 credit, or a \$79 credit?

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Implication

In almost all cases, **it will be better *not* to make the 280C(c) election for a reduced credit.**

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Making the 280C(c) Election

- Made on a timely-filed (with extensions) original return.
- 2022 change
- So ... taxpayers have until 10/15/2023
- So ... nothing to think about for the next year?

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New 280C(c) Caveats

- IRS may fight this: “Scrivener’s error!”
- Would Congress add this to their list
-



Recent Legislation



Inflation Reduction Act of 2022

- **Sec. 13902** – Increase In Research Credit Against Payroll Tax for Small Businesses
 - Beginning after 12/31/2022, increases the limit in any election from \$250k to \$500k
 - Modifies rules and limitations for allowance of the credit, carryovers, and deductions

