



New Year, New Approaches: R&D Credit Changes for 2024

Overview

Strategies for Anticipated Changes

Section 174 Current Status and Updates

Firm Overview



◆ 40+ Years in Business

◆ Serving 8,000+ United States & International Clients

◆ Thousands of Community Service Hours Each Year

◆ 6+ Locations throughout the West Coast

Tax

Business, International, Private Wealth, Research & Development (R&D) Tax Credit, State & Local, Estate & Trust

Audit & Assurance

Financial Statement Audits, Reviews & Compilations, Internal Audit, Sarbanes-Oxley Compliance (SOX), Employee Benefit Plans

Risk Assurance

HIPAA, SOC Reports, ISO Certification, NIST

Consulting

Outsourced Accounting, Lease Accounting, Family Office

Technology

Sage Intacct, ERP, BlackLine, Limelight, Finance Automations

Sustainability

B Corp Certification, SASB Standards & CDP, Impact IQ ESG Assessment, Climate Neutral Certification

CPE Housekeeping

CPE: Answer 75% of the poll questions, which will be all 4 polls sent today.* For breakout rooms, we will record your participation instead of using polls. For full credit, attend for at least 50 minutes.

For internal attendees, complete the course evaluation for the training and provide descriptive feedback.

Communicate with the moderator about tech issues, missed polls, or anything else regarding your participation.

Credit will be issued within two weeks of the training date.

**Credit will be given for any response to polling questions*

Our Speakers



Cole Marr, EA
Director



Ariane Woods, EA
Sr. Manager

Learning Objectives

- ◆ Explain the evolving nuances of R&D tax credit disclosure requirements and the strategic implications
- ◆ Describe anticipated regulatory changes and their impact on your compliance approach
- ◆ Explain the general concept of Section 174 Capitalization requirement as well as the current updates



Agenda

- ◆ What is the R&D Tax Credit?
 - ◆ How much can it mean to my company?
 - ◆ What is eligible?
 - ◆ How is the R&D tax credit calculated?
- ◆ 6765 Disclosures
 - ◆ Proposed changes to the form
 - ◆ What does this mean for you?
- ◆ Section 174 Capitalization Requirement
 - ◆ Legislative update



Section 174 - Current Legislative Update

- ◆ **Tuesday January 16, 2024:** Congress released a Technical Summary of the Tax Relief for American Families and Workers Act of 2024
- ◆ **Wednesday January 17, 2024:** Full bill introduced in the House
 - ◆ Ways and Means Committee voted 40-3 on Friday January 19
 - ◆ Proposes to delay capitalization and amortization for domestic Section 174 expenditures until January 1, 2026
 - ◆ Does not modify foreign Section 174 expenditures
 - ◆ Tax year 2022 may be amended or the deduction taken in current period(s)
- ◆ Has not been voted on in Congress yet – Target is the week of **January 29**
 - ◆ Support from both sides of aisle in both House and Senate



Section 174 - Current Legislative Update

- ◆ **Key Provisions beyond the changes to Section 174:**
 - ◆ Increases the refundable portion of the per-child child tax credit to \$2,000 by 2025
 - ◆ Restores bonus depreciation to 100% for 2023 for property placed in service before January 1, 2026.
 - ◆ Increases the deduction for certain qualifying property from \$1.22M to \$1.29M and indexes for inflation
 - ◆ Terminates the period for making Employee Retention Credit (ERC) claims on January 31, 2024
 - ◆ Additional provisions for Taiwan, Disaster Relief, 1099-NEC and –MISC limits





R&D Credit Overview



Launching Poll #1

R&D Credit Overview

- ◆ Business Credit designed to reward innovation with a net impact between **5-10%** of eligible expenses
- ◆ R&E Credits can be used to **reduce tax liability** and can offset tax to \$0 in the case of restricted NOL carryforward (starting 2021 based on the CARES act removing restriction 2018-2020)*
- ◆ Credits can be carried forward indefinitely (no carryback)
- ◆ Many states have credits as well

*For C-corps with over \$25,000 in regular tax liability, the company can offset no more than 75% of the tax.



R&D Credit – Payroll Tax Offset

- ◆ Qualified Small Businesses can allocate the R&E Credit to offset up to \$500,000 in payroll tax in 2023, up from \$250,000 in 2022 and before
 - ◆ No gross receipts prior to 5 years before the period under review
 - ◆ Gross receipts are under \$5,000,000 in current year
 - ◆ Includes both FICA and Medicare



What is eligible?

- ◆ New or Improved products & processes
- ◆ Business Component: IRS shorthand for “Project”
- ◆ Evolutionary vs. Revolutionary
- ◆ Must meet Four-Part Test
 - ◆ Additional guidelines for software
- ◆ Contract qualification



Credit Amount

- ◆ Percentage over a threshold calculated by a lookback period
 - ◆ Lookback determined by when company started research or prior 3 years
 - ◆ Percentage changes based on which lookback (net ranges from 5-10% of spend)
 - ◆ Traditional
 - ◆ Start-Up
 - ◆ Alternative Simplified



The Four-Part Test

Permitted Purpose

The “why” of the business component. Includes fit, form, functionality, quality, and reliability, among others.



Technological in Nature

Business component must rely on principles of engineering or a hard science. Excludes arts, humanities, and social sciences.



Technological Uncertainty

The business component must have inherent risks related to capability, method, or design for the business component.



Process of Experimentation

A development process relying on a hard science must be used to resolve the uncertainty and demonstrate how a business component progresses.



Excluded Activities

- ◆ Research after commercial production
- ◆ Adaptation and duplication of existing business component
- ◆ Surveys and studies or activities relating to management functions or techniques
- ◆ Research in the social sciences, arts, or humanities
- ◆ General business software
- ◆ Foreign research
- ◆ Funded research



Contract Qualification

- ◆ IP Rights
 - ◆ “Substantial Rights”
 - ◆ Does not need to be exclusive rights
- ◆ Risks
 - ◆ Financial risk must reside with the company taking the credit
 - ◆ Separate from technological risk

Software

- ◆ Internal Use Software (IUS) is not developed for commercial sale, licensing, or otherwise marketed to third parties, or developed to enable interaction with third parties
- ◆ Software developed for commercial sale is not subject to the additional tests
 - ◆ Software developed for use in an activity that constitutes qualified research, used in a production process, or integral to a hardware or software package are not required to meet the high-threshold-of-innovation test.
 - ◆ Intent and Facts-and-Circumstances: the initial intent of the software at the beginning of the activity dictate if the software or the improvement are IUS
 - ◆ Dual-Function Software: the subset of software developed for both internal and external use that can be identified as external is not subject to the additional IUS test.



Software

- ◆ Additional 3-part High-Threshold-of-Innovation test required for Internal Use Software:
 - ◆ **Innovative** as measured by potentially substantial and economically significant improvement
 - ◆ **Significant Economic Risk** by the taxpayer through resources committed and significant uncertainty because of technical risk
 - ◆ **Not Commercially Available** as the taxpayer is unable to purchase, lease, or license



Eligible Expenses -QREs

Wages includes the eligible portion of all taxable compensation. Qualified wages is the portion of an employee's compensation corresponding to the percentage of working time engaged in qualified research.

The entire footprint of the R&D process is eligible including:

Direct Conduct	Direct Supervision	Direct Support
<ul style="list-style-type: none">• Engineers• Scientists• Programmers	<ul style="list-style-type: none">• First-Line Supervisors	<ul style="list-style-type: none">• Production and test personnel• Quality Control• Drafter/Detailers





Eligible Expenses -QREs

Supplies are the materials used to evaluate and test designs throughout the development process.

Eligible supplies may include:

- ◆ Items used in prototype builds
- ◆ Business component performance evaluations
- ◆ Engineering and development software licenses

Eligible Expenses -QREs

Contract Research is outside vendor expenses paid to individuals or other businesses on behalf of the company engaging in qualified research. Generally, if the service performed would be considered an in-house qualified wage expense, the amount is includable.

- ◆ Contract research expenses are included at 65% and must take place in the United States (or in the state where filing a state credit)
- ◆ Expenses paid to some qualified research organizations can be included at 75%
- ◆ Examples include:
 - ◆ Persons or companies paid on a 1099
 - ◆ Testing and certification
 - ◆ Design firms (pursuant to the funded research restrictions)



Launching Poll #2



Expected Disclosure Changes to the R&D Credit for 2024



Timeline of New Disclosure Requirements



October 2021

Chief Counsel Memorandum specifying additional data required for claims for refund starting after January 10, 2022 foreshadows current changes



December 2022

IRS alerts to potential changes to the form with details to be released in 2023 (Speculation was this might be for tax year 2023)



September 2023

IRS releases Rev Proc 2023-63 with a draft of the proposed form and clarifies this is for tax year 2024 and later



October 2023

Comments were due to IRS



January 2024

Companies with a 12/31/2024 tax year should start to make any adjustments to internal tracking to ease compliance



March 2025

First tax returns for tax year 2024 will be due





Proposed Changes to 6765

IR-2023-173 – Released Sept 15, 2023

- ◆ Proposed additional detail on form about the company and business components
- ◆ Consistent and predefined format for reporting
- ◆ Help reduce inflated claims and focus IRS resources
- ◆ IRS looking to make sure taxpayers are scaling back properly for non-qualified activities and portions of business components

Detail of Additional Reporting

- ◆ **280C election and Control Group yes/no boxes**

Form 6765 (Rev. December XXXX) Department of the Treasury Internal Revenue Service	Credit for Increasing Research Activities Attach to your tax return. Go to www.irs.gov/Form6765 for instructions and the latest information.	OMB No. 1545-0619 Attachment Sequence No. 81
Name(s) shown on return		Identifying number
A Are you electing the reduced credit under IRC 280C (see instructions)? Yes <input type="checkbox"/> No <input type="checkbox"/> B Are you a member of a controlled group or business under common control? Yes <input type="checkbox"/> No <input type="checkbox"/>		
Section A—Regular Credit. Skip this section and go to Section B if you are electing or previously elected (and are not revoking) the alternative simplified credit.		
1 Certain amounts paid or incurred to energy consortia (see instructions)	1	

- ◆ **Payroll Tax Offset under Section 41(h) updates**

Credit on Form 990, Part III, line 10	40
Section D—Qualified Small Business Payroll Tax Election and Payroll Tax Credit. Skip this section and go to Section E if the payroll tax election does not apply. See instructions.	
41a Check this box if you are a qualified small business electing the payroll tax credit. See instructions <input type="checkbox"/>	
b Check this box if payroll tax is reported under a different EIN. <input type="checkbox"/>	
42 Enter the portion of line 36 elected as a payroll tax credit (do not enter more than \$500,000). See instructions	42
43 General business credit carryforward from the current year (see instructions). Partnerships and S corporations, skip this line and go to line 44	43
44 Partnerships and S corporations, enter the smaller of line 36 or line 42. All others, enter the smallest of line 36, line 42, or line 43. Enter here and on the applicable line of Form 9974, Part 1, column (e). Members of controlled groups or businesses under common control, see instructions for the statement that must be attached	44

Detail of Additional Reporting

- ◆ Section E – Other Information
 - ◆ Enables IRS reviewer to check for a number of potential complicating factors
 - ◆ Mergers, Acquisitions, Dispositions
 - ◆ Consistency Requirement
 - ◆ Officer Wages included in QREs
 - ◆ ASC 730 Directive

Section E—Other Information (See instructions)		
45	Enter the number of business components generating the credit computed on line 15 or line 32	45
46	Enter the amount of officers' wages included in line 5 or line 24	46
47	Did you acquire or dispose of any major portion of a trade or business in the tax year? Yes <input type="checkbox"/> No <input type="checkbox"/>	
48	Did you identify any new categories of expenditures included in the current year QRE? Yes <input type="checkbox"/> No <input type="checkbox"/>	
49	Did you determine any of the QREs on line 9 or line 28 following the ASC 730 Directive? Yes <input type="checkbox"/> No <input type="checkbox"/> If "Yes," enter the amount from Appendix C, Line 19	49
This ASC 730 Directive only applies to taxpayers with assets equal to or greater than \$10,000,000 who follow U.S. GAAP to prepare their Certified Audited Financial Statements showing the amount of currently expensed Financial Statement R&D. See instructions.		

Form **6765** (Rev. 12-XXXX)



Detail of Additional Reporting

Section F – Business Component Info

- ◆ Additional detail on form about the company and business components
- ◆ 50(e)-(h) are drop down details and list provided by IRS
- ◆ 51-54 break out the wage QREs into direct, supervision, and support
 - ◆ This is often seen in audit

Form 6765 (Rev. 12-2000) Page 3

Section F—Business Component Information. Information for each Business Component (BC) (see instructions). Complete Lines 50 through 57 for each business component. If you have more than ten business components, see instructions.

BC	50(a) EIN of the controlled group member conducting the research activities on this business	50(b) Controlled group member's principal business activity code	50(c) Business component's descriptive name	50(d) Describe the information sought to be discovered and identify the one or more alternatives evaluated in the process of experimentation for each business component. Use the space provided.
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				

BC	50(e) Is the business component new or improved (select one)	50(f) Business component type (select one from available options)	50(g) Business component use (select one from available options)	50(h) Software (if applicable, select one from available options)
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				

BC	51 Direct research wages for qualified services	52 Direct supervision wages for qualified services	53 Direct support wages for qualified services	54 Total qualified wages (Add line 51, line 52, and line 53)
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				

Form 6765 (Rev. 12-2000)

What can clients do to prepare?

- ◆ If the client has good compliance to time tracking and project level accounting:
 - ◆ Few changes needed! Make sure managers are tracking time to projects as much as possible and supplies and contractors are clearly being allocated
- ◆ If the client does NOT have time tracking or poor compliance, now is a good time to implement or encourage compliance
 - ◆ Have personnel accurately track hours worked – whether its 35 hours or 53 per week
 - ◆ Remind supervisors to charge time to projects as appropriate
 - ◆ Make sure support personnel in quality, manufacturing, and production are tracking time



What can clients do to prepare?

- ◆ If time tracking is not an option (most Tech clients), consider completing surveys in 2024.

Include:

- ◆ Project list and portion of time by person for each (hours or percentage)
- ◆ Activities performed during the period
- ◆ Include the project name as its own field or as part of the memo line to enable data analysis
- ◆ While the IRS is considering making completing part F optional for companies with a credit below a certain amount, QREs below a threshold, or those taking the Payroll Tax Offset under Section 41(h), the release indicates that maintaining and then providing this level of detail is expected
 - ◆ Unlikely the IRS will clarify prior to the start of 2024



Launching Poll #3



Sec. 174 Capitalization Requirement

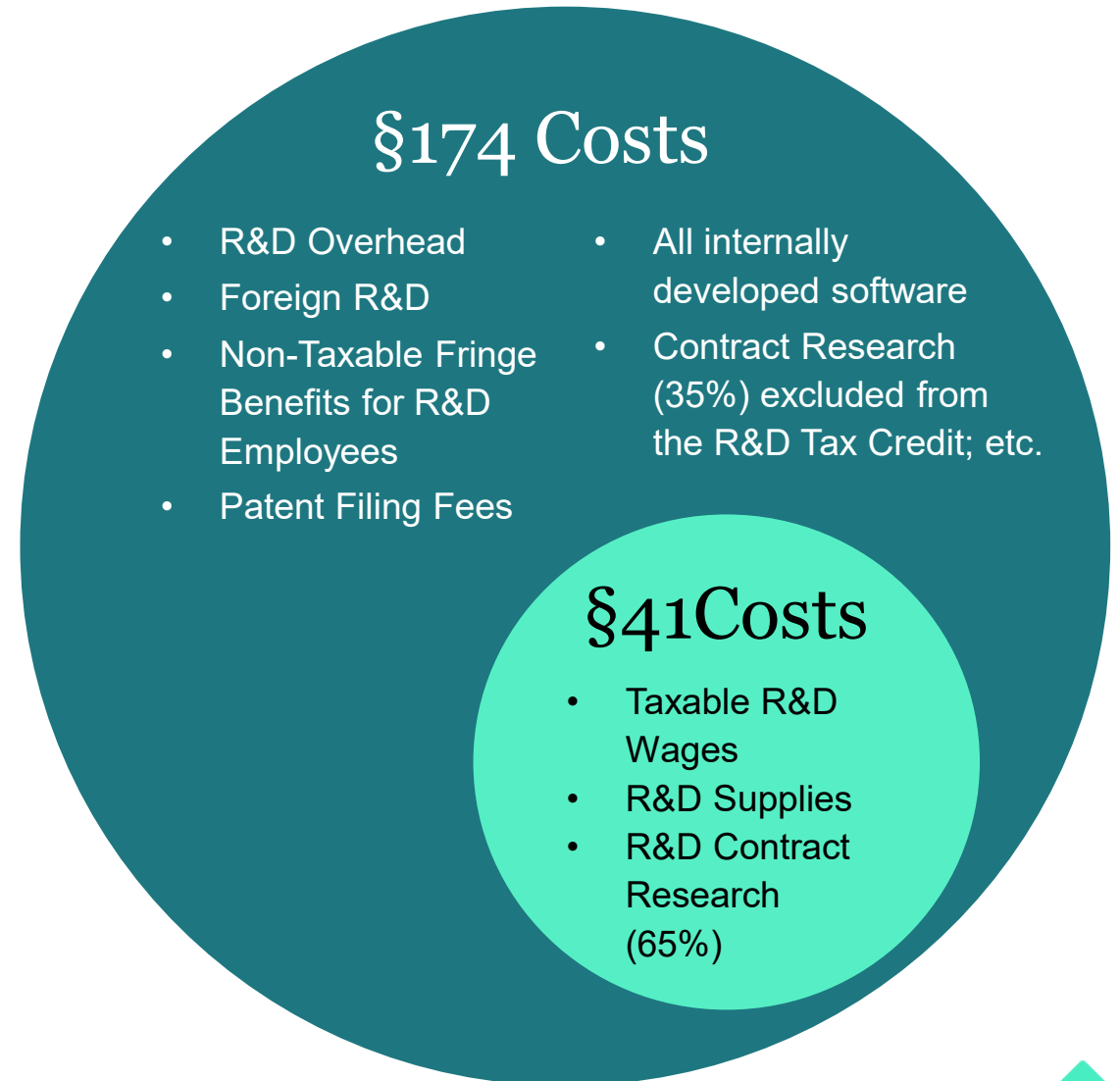
What is “Section 174” of the Tax Code?

- ◆ **What is Section 174 of the Tax Code:** section that governs the definition and tax treatment of research or experimental expenditures (commonly referred to as "R&E expenditures", "R&D expenditures", or “§ 174 costs”).
- ◆ **Background:** TCJA require Capitalization and amortization of R&E costs for tax years beginning after 12/31/21
 - ◆ Previously this was optional, though once elected could only be revoked with consent
 - ◆ While many states conform to federal, California is one that does not conform (no need to amortize)
- ◆ **Capitalization is mandatory**
 - ◆ While Sec. 41 (R&E Credit) is a subset of Sec. 174 (Research and Experimental Expenditures), claiming no tax credit will not relieve the taxpayer from the requirement to identify and quantify Sec. 174 expenses
- ◆ **Amortization**
 - ◆ 5 years (15 years for expenses that are attribute to foreign research) using midyear convention
 - ◆ For 2022, this means only 10% of US expenses and 3.33% of foreign are amortized



R&D Deduction (§174) vs. R&D Credit (§41)

- ◆ § 41 establishes the R&D Tax Credit;
§ 41 costs are a subsection of § 174 costs
- ◆ The R&D Tax Credit provides a separate incentive to reduce tax liability with a credit for certain incremental R&D costs



Note: Since no longer deducting R&D expenses due to 174 change, it no longer makes sense to take the 280C election on the R&D Credit under Section 41.

Detail of 174 Expenses

- ◆ Section 41 R&D cost – see notes
 - ◆ Wages – uses GROSS (not taxable comp) and no substantially all rule
 - ◆ Supplies
 - ◆ Outside contractors (at 100%)
- ◆ All patent expenses
- ◆ All software development costs
 - ◆ May be higher than Sec. 41 costs
- ◆ International R&D Expenses

- ◆ Other costs incidental to R&D
 - ◆ Employer Payroll Taxes
 - ◆ Employer portion of healthcare costs
 - ◆ Employer 401k contributions + other fringe
 - ◆ Allocated portion of Utilities
 - ◆ Rent/mortgage + taxes
 - ◆ Electrical/Gas/Internet
 - ◆ Security/Sanitation
 - ◆ Insurance
 - ◆ Portion of office/shop supplies



Section 174

- ◆ **Specified research and experimental expenditures** under Section 174 are R&D expenditures paid or incurred by the taxpayer during such taxable year in connection with the taxpayer's trade or business
- ◆ **IRS regulations and guidance still in draft** for accurate determination of Sec. 174 expenditures
 - ◆ Generally, the definition of eligible activity from Section 41 – Research and Experimentation Tax Credit will likely be used
 - ◆ Amounts included under Section 174 are broader than Section 41
 - ◆ [Rev Proc 2023-63](#) released in September 2023 is interim guidance ahead of proposed regulations
 - ◆ [Rev Proc 2024-12](#) released in late December 2023 adds clarity to contract research expenses and aligns the guidance for IP Rights and Financial Risk to Section 41 definitions



Section 174

- ◆ **Automatic change in accounting method**

- ◆ For tax year 2022, [Rev Proc 2023-11](#) allows an automatic change of accounting methods in lieu of the form 3115. Subsequently included in [Rev Proc 2023-24](#) List of Automatic Changes
 - ◆ Detailed listing of items needed: <https://ssfilp.com/rd-capitalization-and-amortization/>
- ◆ Rev Proc 2023-24 also reminds taxpayers that if they are making the change after 2022, they are required to file form 3115 and includes a modified Section 481(a) adjustment for 2022
- ◆ [Rev Proc 2024-09](#) allows taxpayers an automatic consent to change accounting methods in order to align with the interim guidance for Section 174 released in 2023-63 in September 2023
 - ◆ While the taxpayer is not required to file form 3115, they are required to include a modified Section 481(a) adjustment for tax year 2022
 - ◆ Note, however, that the Section 481(a) adjustment is optional for negative amounts
- ◆ Form 3115 is NOT required if 2023 is the company's first year of eligible expenditures, or have no established accounting method



Launching Poll #4



Q&A





Thank you!

Contact Us

Cole Marr

cmarr@sensiba.com

408-673-3010

Sensiba.com

