



Cole Marr | Ariane Woods

Fuel Your Startup's Growth: **A Guide to R&D Tax Credits for Tech Ventures**



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

Our Speakers



Cole Marr, EA
Partner



Ariane Woods, EA
Sr. Manager

Agenda

- ◆ Intro to R&D Credits
 - ◆ Overview
 - ◆ Payroll Tax Offset
- ◆ What Qualifies for the R&D Tax Credit
 - ◆ Four-Part Test
 - ◆ What is eligible?
 - ◆ Credit Amount
- ◆ Section 174 Capitalization Requirement
- ◆ Expected Disclosure Changes for 2024
- ◆ Next Steps





Introduction to R&D Credits



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
 - ◆ Offsets both FICA and Medicare





What Qualifies for the R&D Tax Credits?



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.



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



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)



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



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





Sec. 174 Capitalization Requirement

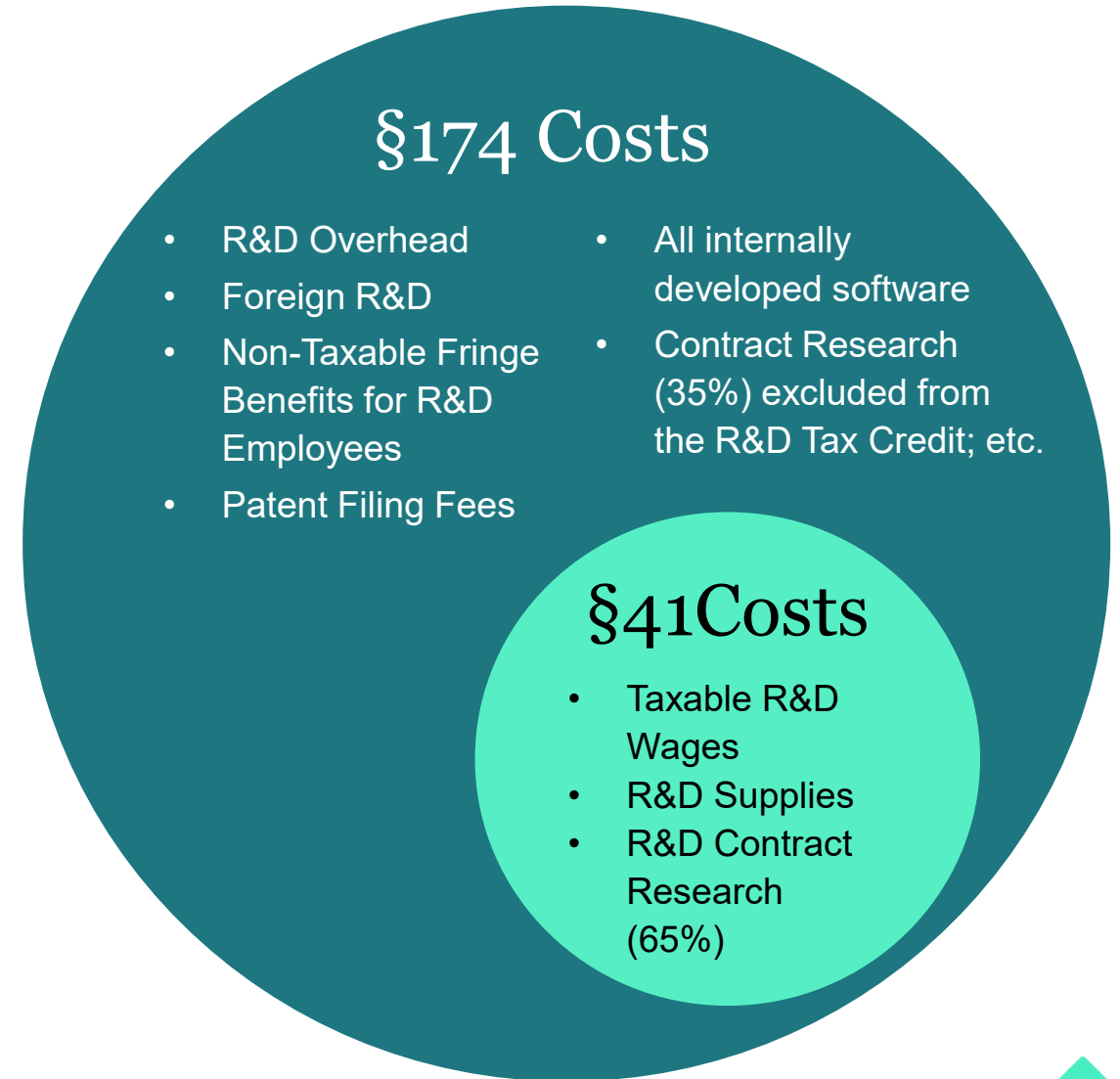
What is “Section 174” of the Tax Code?

- ◆ **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 2023, this means only 10% of US expenses and 3.33% of foreign are amortized



§174 SREs vs. §41 QREs

- ◆ § 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





Expected Disclosure Changes to the R&D Credit for 2024





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

What can you do to prepare?

- ◆ If your team 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 you do 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 you do to prepare?

- ◆ If time tracking is not an option (most companies), consider completing surveys throughout 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 GL 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 2nd half of 2024





Preparing for R&D Tax Credits: Next Steps



Next Steps

- ◆ Contact Cole Marr for a short (generally 20 minute) call about your opportunity
- ◆ Don't change your internal process!
 - ◆ Our team will review what you have and work with existing documents and processes
 - ◆ We might make suggestions for future years to simplify the credit reporting
- ◆ Let us take the headache out of getting your R&D Credit(s)





Q&A





Thank you!

Contact Us

Cole Marr

cmarr@sensiba.com

408-673-3010

Sensiba.com

