



Navigating the R&D Tax Credit in 2025: Strategic Insights and Compliance Essentials

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

◆ Six Locations With Professionals Across the Country

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
Partner



Ariane Woods, EA
Sr. Manager

Learning Objectives

- ◆ Explain the evolving nuances of R&D tax credit disclosure requirements and the strategic implications
- ◆ Describe 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
 - ◆ Changes on the Draft Form
 - ◆ What does this mean for you?
- ◆ Section 174 Capitalization Requirement
 - ◆ Legislative update



Section 174 - Legislative Update

- ◆ **January 29, 2024:** House votes 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)
- ◆ **August 1, 2024:** Senate fails to pass with 48 votes for and 44 against
- ◆ **Fall 2024:** IRS releases several revenue procedures for Section 174
 - ◆ No legislative movement on a fix





R&D Credit Overview



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)*
- ◆ Federal credit can be carried forward 20 years, CA is indefinite (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



* 5-TY period counts from the earlier of the first year of receipts (including interest/other income) or the first year of 41(h) election.

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
- ◆ Most states have credits as well
 - ◆ California mirrors the federal Traditional/Start-up and the no longer used federal Alternative Incremental



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



** Excluded by statute – this is a subset of the full list*

R&D Credit – Things to Watch out For

- ◆ Contract Qualification
 - ◆ “Substantial Rights” to the Intellectual Property (IP) does not need to be exclusive rights
 - ◆ Financial risk must reside with the company taking the credit, separate from technological risk
- ◆ Software
 - ◆ Internal use software (IUS) or Dual Use
 - ◆ Additional 3-part test: Innovative, Significant Economic Risk, Not Commercially Available
- ◆ Computer rental and assigning jurisdiction for federal and state allocations



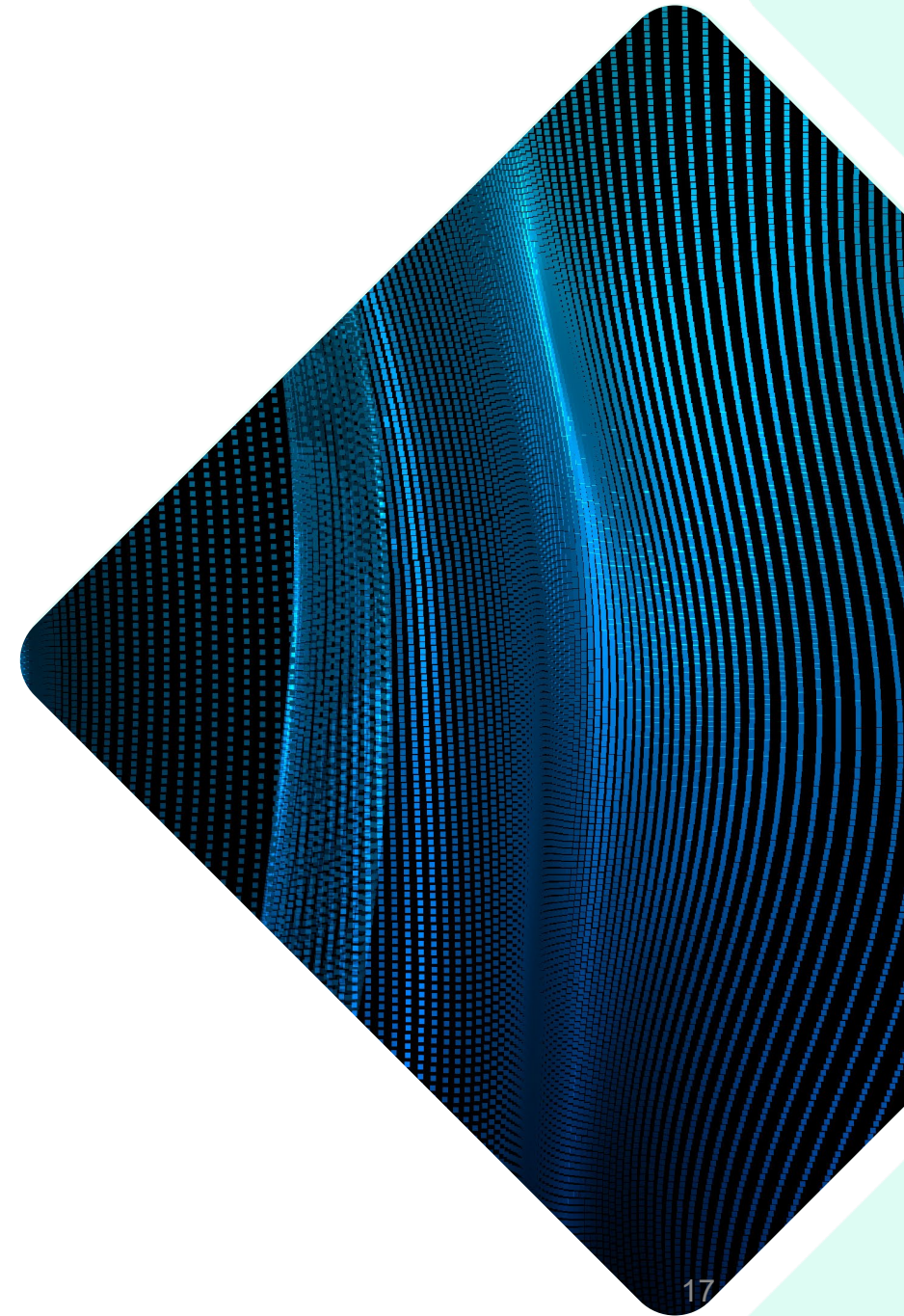
Software

- ◆ 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

Computer Rental is used for Cloud Computing such as AWS and other cloud server/hosting development and test environments.

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)



Disclosure Changes to the R&D Credit for 2024 and 2025



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 proposed form and clarifies this is for tax year 2024 and later.



June 2024

Draft of the 6765 released with changes based on feedback the IRS received.



December 2024

2nd draft of form released, simplifying the original draft and making detailed project reporting mandatory starting TY 2025



January 2025

Instructions for the draft form released on the 2nd. Final form not yet released as of Jan 27, 2025.





Draft Changes to 6765

IR-2023-173 – Released Sept 15, 2023,

Updated draft released December 12, 2024

Instructions released January 16, 2025

- ◆ 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 2024) 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. 676
Name(s) shown on return		Identifying number
A Are you electing the reduced credit under section 280C? See instructions <input type="checkbox"/> Yes <input type="checkbox"/> No		
B Are you a member of a controlled group or business under common control? <input type="checkbox"/> Yes <input type="checkbox"/> No If "Yes," complete and attach the required statement. See instructions for required attachment.		

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

Section D—Qualified Small Business Payroll Tax Election and Payroll Tax Credit. Skip this section if the payroll tax election does not apply. See instructions.	
33a Check this box if you are a qualified small business electing the payroll tax credit. See instructions <input type="checkbox"/>	
b Check the box if payroll tax is reported on a different EIN <input type="checkbox"/>	
34 Enter the portion of line 28 elected as a payroll tax credit (do not enter more than \$500,000). See instructions	34
35 General business credit carryforward from the current year. See instructions. Partnerships and S corporations, skip this line and go to line 36	35
36 Partnerships and S corporations, enter the smaller of line 28 or line 34. All others, enter the smallest of line 28, line 34, or line 35. Enter here and on the applicable line of Form 8974, Part 1, column (e). Members of controlled groups or businesses under common control, see instructions for the statement that must be attached	36

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.

37	Enter the number of business components generating the QREs on line 5 or line 20	37	
38	Enter the amount of officers' wages included on line 42	38	
39	Did you acquire or dispose of any major portion of a trade or business in the tax year? <input type="checkbox"/> Yes <input type="checkbox"/> No		
40	Did you include any new categories of expenses as current year QREs? <input type="checkbox"/> Yes <input type="checkbox"/> No		
41	Did you determine any of the QREs on line 5 or line 20 following the ASC 730 Directive? <input type="checkbox"/> Yes <input type="checkbox"/> No		
	If "Yes," enter the amount from Appendix C Line 19 (you may attach your Appendices A, B, C, and D here)	41	
	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.		

Detail of Additional Reporting

◆ Section F – QRE Summary

◆ Line A –

Section F—Qualified Research Expenses Summary. See instructions.

A Are you required to complete Section G? See instructions to determine if you are required to complete Section G, and how to complete Section F if you are not required to complete Section G Yes No

42 Total wages for qualified services for all business components (do not include any wages used in | |

- ◆ Is Section G mandatory? Optional for all companies in 2024
- ◆ Mandatory in 2025 UNLESS:
 - ◆ Payroll Tax Offset AND reduced credit elected
 - ◆ Gross Receipts Under \$50M for the current year AND under \$1.5M QREs
- ◆ Rest of section is summary of QREs (detail in Section G if needed)



Detail of Additional Reporting

Section G – Business Component Info

- ◆ Additional detail on form about the company and business components
- ◆ 49(d) and (e) are drop down details and list provided by IRS
- ◆ Business components are to be sorted in decreasing order and the top 50 or BCs representing 80% of total QREs reported. Remainder of BCs are reported in aggregate.

Form 6765 (Rev. 12-2024)

Page **3**

Section G – Business Component Information. Complete lines 49(a) through 49(f) for each business component you are required to report. See instructions. Attach additional sheets if necessary to capture all business components.

BC	49(a)	49(b)	49(c)	49(d)
	EIN of the controlled group member conducting the research activities on this business component	Controlled group member's principal business activity code	Business component's name or unique alphanumeric identifier (see instructions)	Business component type (select one from available options)
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				
BC	49(e)	49(f)		
	Software (if applicable, select from the available options)	Describe the information sought to be discovered. Use the space provided.		
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				

Form **6765** (Rev. 12-2024)

Detail of Additional Reporting

Section G – Business Component Info

- ◆ 50-53 break out the wage QREs into direct, supervision, and support
 - ◆ This is often seen in audit
- ◆ 54-56 allocate Supply, Computer, and Contract Research by BC
 - ◆ Also common in audit
- ◆ Summations in lines 58-64 then flow back to section F for credit computation

Section G – Business Component Information (continued). Complete lines 50 through 56 for each business component. If you have more than fifteen business components, see instructions.

BC	50 Direct research wages for qualified services	51 Direct supervision wages for qualified services	52 Direct support wages for qualified services	53 Total qualified wages (add line 50, line 51, and line 52)
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				
Total from attachments				
Total				
BC	54 Cost of supplies	55 Rental or lease cost of computers	56 Applicable amount of contract research expenses (see instructions for reporting basic research payments)	
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				
Total from attachments				
Total				

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 for 2024 and during 2025. 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
- ◆ Completing part G is optional for all companies in 2024 and for some companies in 2025; however, the IRS expects all this information available if there are questions.



Sec. 174 Capitalization Requirement

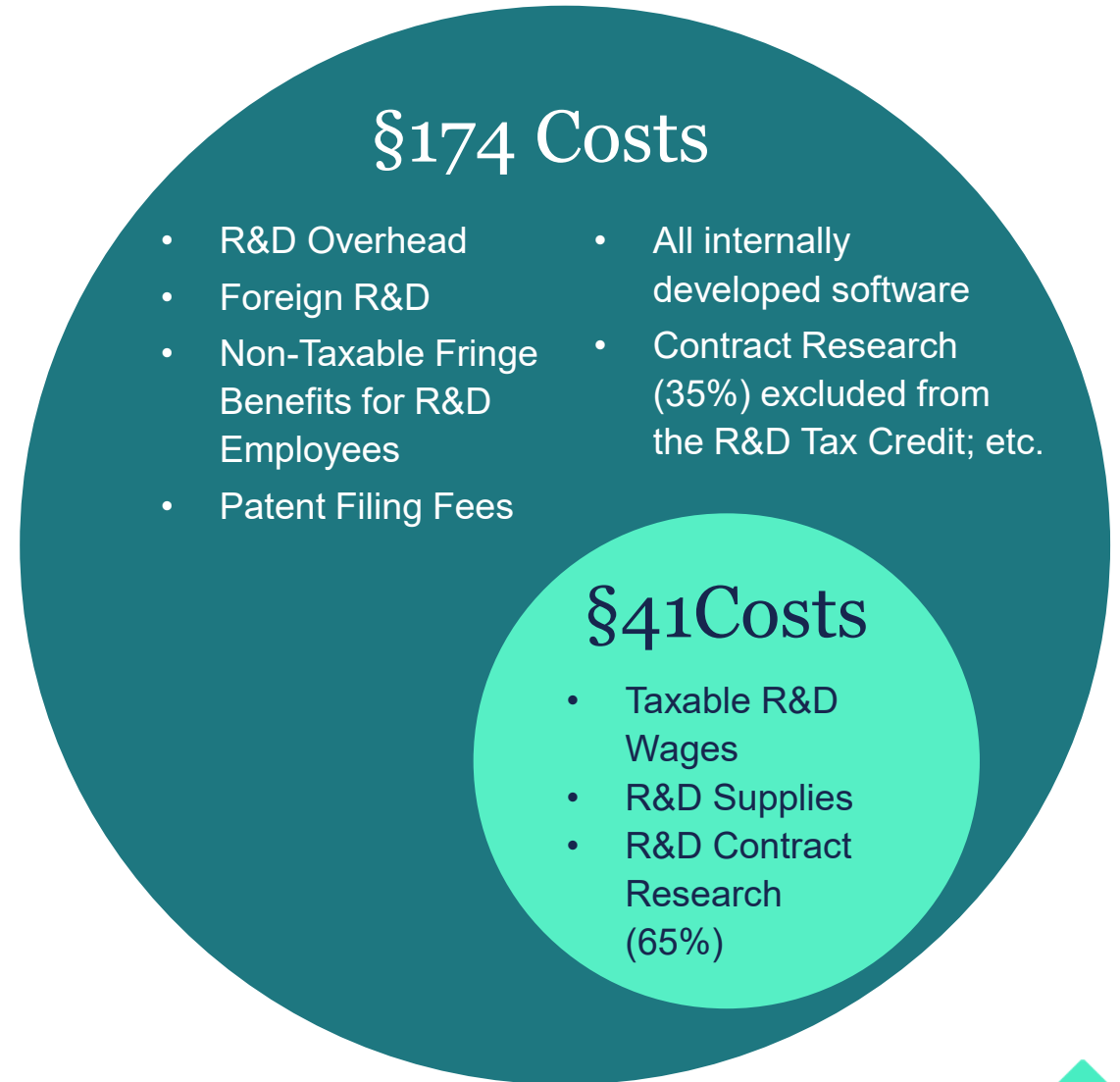
What is “Section 174” of the Tax Code?

- ◆ **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 SREEs, "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
- ◆ **Capitalization is mandatory**
 - ◆ While Sec. 41 (R&E Credit) is a subset of Sec. 174 (Research and Experimental Expenditures), claiming no tax credit does 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 2024, this means only 10% of US expenses and 3.33% of foreign are amortized (with 20% and 6.66% of prior years domestic and foreign expenses, respectively)



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
 - ◆ [Rev Proc 2023-63](#) released in September 2023 is interim guidance ahead of proposed regulations
 - ◆ Generally, use the definition of eligible activity from Section 41 – R&E Tax Credit
 - ◆ Amounts included under Section 174 are broader than Section 41
- ◆ **Automatic change in accounting method** – allowed in 2024 for capitalization methods (if needed)
 - ◆ [Rev Proc 23-11](#) for instructions on the initial return attachment
 - ◆ [Notice 2024-12 and Rev Proc 2024-09](#) aligned regulations with Sec 41
 - ◆ [Rev Proc 2024-23](#) updated the list of automatic accounting methods to include 174 (start on page 152)
 - ◆ [Rev Proc 2024-34](#) corrected potential issues with short years for 174



Possible Changes for Section 174

- ◆ Section 174 is currently the law for 2024 just like 2022-2023
- ◆ Congress has drafted revocation bills multiple times
 - ◆ Last attempt was June 2024: passed the House in Jan 2024, did not pass Senate
 - ◆ Changes for TY 2024? – Legislative timeline unknown
 - ◆ Almost certain to retain foreign R&D amortization requirement
- ◆ IRS targets releasing Regulations in early 2025
 - ◆ Regs expected to substantially mirror the current guidance
- ◆ State conformity – most states currently conform to Federal*
 - ◆ California, Georgia, Indiana, Mississippi, Tennessee, Texas, and Wisconsin do NOT conform
 - ◆ Nevada, Ohio, South Dakota, Washington, and Wyoming are n/a due to corporate tax structure

We have covered today:

- ◆ The R&D Credit and the eligible expenses
- ◆ Changes to the R&D Credit tax form 6765 for tax years 2024 and 2025
- ◆ Section 174 and how it differs from the R&D Credit
- ◆ Some of the possible changes to Section 174 for tax year 2024 and beyond



Q&A





Thank you!

Contact Us

Cole Marr

cmarr@sensiba.com

408-673-3010

Sensiba.com

