Claiming the Section 41 R&D Credit: Small Business Provisions

THURSDAY, DECEMBER 12, 2019, 1:00-2:50 pm Eastern

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Claiming the Section 41 R&D Credit: Small Business Provisions

December 12, 2019

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Research & Development Credit
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• 20+ years specializing in Research & Development (R&D) credits, deductions and deferrals

• Deep technical knowledge in helping companies identify, increase, document and support claims of federal and state R&D credits across all industries, saving companies millions of dollars in taxes each year

• Big Four alumni with 13 years working on some of the nation’s largest research credit projects

• Experience with the IRS and state authorities across the country
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AGENDA

Overview of Section 41 R&D credit

Four-part test to determine QRAs

IRS regulations on internal-use software inclusion in QRA calculations
Overview of Section 41 R&D credit
Overview of Section 41 R&D credit

• Research and Development (R&D) credit been around 1980s as temporary but now permanent!
  • Part of the 2015 PATH Act
  • 18th extension a charm!

• R&D credit
  • Cash and tax benefit increased due to the lowering of the corporate tax rates starting with 2018 year
  • Reduced credit benefit was 65% (1-35%); now reduced credit benefit 79% (1-21%)

• Tax Cuts and Jobs Act of 2017
Overview of Section 41 R&D credit

- Two new changes for eligible small businesses
  - Starting tax year 2016
  - Offset credit against payroll tax
    - Instead of using it against income tax
    - Offset credit against AMT

- Tax Cuts and Jobs Act
  - Repeals corporate AMT
Four Part Test of Qualified Research Expenses (QREs)
“Qualified Research” Defined

- Four-part test
  - Expenses under §174 - Uncertainty
  - Technological in nature
  - New or improved business component
  - Process of experimentation
Uncertainty under Section 174

• Under § 174, taxpayer must be uncertain about:
  • If or can it be done (capability)? or
  • How can it be done (method)? or
  • What is the appropriate design?
Technological in Nature

• Research is technological in nature if it relies on principles of the physical or biological sciences, engineering, or computer science.

• Research based on economic principles (e.g., financial services or products) does not qualify.
New or Improved Business Component

• The development activities must relate to a new or improved function, performance, reliability, or quality of the business component.

• Development activities relating to style, taste, cosmetic, or seasonal design factors do not qualify.
Business Component

• Includes:
  • Product
  • Process
  • Computer software
  • Technique
  • Formula
  • Invention

• Held for sale, lease, license to customers or use by taxpayer in their trade or business
Process of Experimentation Test

• “A process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or method of achieving that result is uncertain as of the beginning of the taxpayer’s research activities.” Reg. §1.41-4(a)(5)

• “Substantially all” (≥80%) of the activities must constitute elements of a process of experimentation that relates to a qualified purpose. Reg. §1.41-4(a)(6)
Exclusions

• Activities that specifically do not qualify for the credit Reg. §1.41-4(c)
  • After the beginning of commercial production
    • Meets the taxpayer’s Economic or Functional requirements
  • Adaptation of existing business component
  • Duplication / Reverse engineering
  • Market research
  • Quality control
  • Non-U.S. research – where the work is performed
  • Funded research
  • Internal-use Software (additional requirements)
Exclusions

Funding

• Taxpayer must have **Risk** AND **Rights** to research

  • **Risk** - Requires the taxpayer to bear the expense even if the research is not successful. Reg. §1.41-2(e)(2)(iii)

  • **Rights** - The taxpayer has a right to the research results. The taxpayer does not have exclusive rights to the results. Reg. §1.41-2(e)(3)

Research vs. Product
Qualified Research Expenses

Qualified
- Wages
- Supplies
- Lease computers costs
- Contract research

Can be expensed or capitalized
Qualified Wages

- Substantially All - Eighty percent rule Reg. §1.41-2(d)(1)

“if substantially all of the services performed by an employee… [qualify], then the term “qualified services” means all of the services performed by the employee for the taxpayer during the taxable year…”

If ≥80% qualify then 100% of the wages qualify for that employee. As noted previously, the denominator is the “performance of services” so vacation, sick time, and holiday time is excluded from the calculation.
Supplies

• Tangible property - other than land or improvements to land and property not subject to depreciation - all used in the conduct of qualified research.
Leased Computer Costs

• Originally when companies could not afford to purchase computers

• Now: Cloud Computing or On-demand computing platforms
  • Development use
  • i.e. Amazon Web Services
  • Where are the servers?
Contract Research Expenses

• “65 percent of any amount paid or incurred… for qualified research”
• Must meet two tests:
  • Economic risk
  • Rights in development
Mechanics of the Credit

• The credit rewards increases in research spending.
• Two federal computational methods:
  • “Regular” or Fixed Base
  • Alternative Simplified Credit (ASC)
• How/when computational methods elected
  • An election (on an original, timely filed tax return) shall apply to the taxable year and all succeeding years
Regular or “Fixed” Base Percentage

- Fixed Base % = \( \frac{\text{Total 1984 - 1988 QREs}}{\text{Total 1984 - 1988 Gross Receipts}} \)
- Base Period - Taxable years beginning after 12/31/1983 and before 1/1/1989
- Can never exceed 16 percent
- Start-up entities must use three percent
  - Those without both gross receipts and QREs for at least three tax years in the base period
Taxpayers with QREs and gross receipts for fewer than three tax years beginning after 1983 and before 1989 or QREs and gross receipts for the first time after 1983

First five tax years after 1993 that taxpayer has QREs – three percent fixed-base percentage

<table>
<thead>
<tr>
<th>Year</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sixth Year</td>
<td>((2XX4 + 2XX5 \text{ QREs/GR}) \times \frac{1}{6})</td>
</tr>
<tr>
<td>Seventh Year</td>
<td>((2XX5 + 2XX6 \text{ QREs/GR}) \times \frac{1}{3})</td>
</tr>
<tr>
<td>Eighth Year</td>
<td>((2XX5 \text{ to } 2XX7 \text{ QREs/GR}) \times \frac{1}{2})</td>
</tr>
<tr>
<td>Ninth Year</td>
<td>((2XX5 \text{ to } 2XX8 \text{ QREs/GR}) \times \frac{2}{3})</td>
</tr>
<tr>
<td>Tenth Year</td>
<td>((2XX5 \text{ to } 2XX9 \text{ QREs/GR}) \times \frac{5}{6})</td>
</tr>
<tr>
<td>Eleventh Year</td>
<td>Best 5 of 5-10 yrs QREs/GR</td>
</tr>
</tbody>
</table>
Gross Receipts Defined

- Generally, gross receipts is the total amount, as determined under the taxpayer’s method of accounting, derived by the taxpayer from all sources.

- Broad definition of gross receipts includes:
  - Form 1120 Lines 1c, 4, 5, 6, 7, 10
### Qualified Wages
500,000

### Qualified Supplies
20,000

### Qualified Contract Research @ 65%
65,000

**Qualified Research Expenditures "QRE"**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualified Wages</td>
<td>500,000</td>
</tr>
<tr>
<td>Qualified Supplies</td>
<td>20,000</td>
</tr>
<tr>
<td>Qualified Contract Research @ 65%</td>
<td>65,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$585,000</strong></td>
</tr>
</tbody>
</table>

### Regular Credit Calculation

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>QREs</strong></td>
<td>585,000</td>
</tr>
<tr>
<td><strong>Average Annual Gross Receipts</strong></td>
<td>17,900,000</td>
</tr>
<tr>
<td><strong>Fixed Base %</strong></td>
<td>1.03%</td>
</tr>
<tr>
<td><strong>Base Amount</strong></td>
<td>184,370</td>
</tr>
<tr>
<td><strong>A - B</strong></td>
<td>400,630</td>
</tr>
<tr>
<td><strong>A * 50%</strong></td>
<td>292,500</td>
</tr>
<tr>
<td><strong>Min C or D</strong></td>
<td>292,500</td>
</tr>
<tr>
<td><strong>E*20% Credit “Regular”</strong></td>
<td>$58,500</td>
</tr>
<tr>
<td><strong>E*15.8% 280C Credit “Reduced”</strong></td>
<td>$46,215</td>
</tr>
</tbody>
</table>
Alternative Simplified Credit (ASC)

- At the election of the taxpayer,
- 14 percent of the amount by which QRE exceeds 50 percent of average QRE from the prior three tax years

![Diagram showing QREs for three years and the calculation of QRE credit at 14% or no credit based on exceeding 50% of the three-year average.]
ASC
Start-up Companies

• If the taxpayer does not have QREs in ALL 3 preceding tax years including if the company did not exist in 3 prior years, then the current year QREs are multiplied against a 6% rate.

Consistency Requirement
• Whether the length of filing year, length of base years, way of computing QREs, etc. there must be a consistent treatment of expenses. The determination year and base years must be determined consistently.
<table>
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<td>65,000</td>
</tr>
<tr>
<td>Qualified Research Expenditures &quot;QRE&quot;</td>
<td>$585,000 A</td>
</tr>
</tbody>
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<table>
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<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>QREs</td>
<td>585,000 A</td>
</tr>
<tr>
<td>3 prior yrs QREs</td>
<td>1,580,000 Z</td>
</tr>
<tr>
<td>Z * 1/6</td>
<td>263,333 Y</td>
</tr>
<tr>
<td>A – Y</td>
<td>321,667 X</td>
</tr>
<tr>
<td>X * 14% credit “Regular”</td>
<td>45,033</td>
</tr>
<tr>
<td>X * 11.1% 280C credit “Reduced”</td>
<td>35,576</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Last year QREs</td>
<td>575,000</td>
</tr>
<tr>
<td>2nd year QREs</td>
<td>520,000</td>
</tr>
<tr>
<td>3rd year QREs</td>
<td>485,000</td>
</tr>
<tr>
<td>3 prior year of QREs</td>
<td>1,580,000</td>
</tr>
</tbody>
</table>
Maximum Incremental Credit Rates

Elected on original, timely filed return - once elected, irrevocable for that year.

- “Regular” credit – 20%, or 15.8% under reduced credit election

- “ASC” credit is to 14%, or 11.1% under reduced credit election
**Reduced Credit Illustrated**

<table>
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<tr>
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</thead>
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<tr>
<td>Min C or D</td>
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<td>$46,215</td>
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If one doesn’t elect the 280C Reduced Credit, then:

- Add the Regular Credit into income: $58,500
- Tax on the additional income at 21%: $12,285

Net effect of using the Regular Credit:

- Regular Credit: $58,500
- Tax on additional income: $12,285
- Net Benefit: $46,215

**Unless taking the Payroll Tax Offset** - Always elect the reduced credit
- The starting point for most states (Federal Taxable Income) would be lower
- Administratively easier (including if an Amended Return ever were filed on that return)
- Same net benefit
IRS regulations on internal-use software
Internal Use Software

- Is the software for use in an activity that constitutes qualified research?
- Developed for use in a production process that meets the requirements of qualified research?
- Developed with hardware as a single product?
- Is the Software to be Sold, Leased, Licensed?
- Developed for taxpayer to interact with/allow 3rd parties to initiate functions or review data on taxpayer’s system?

If any of these answers is a “Yes” ----> then no High Threshold of Innovation Test
Internal Use Software
IRS Focus Area

• Innovative — if software would result in a
  • Reduction in cost or
  • Improvement in speed or
  • Other measurable improvement that is substantial and economically significant
    (Objective standard, no longer unique and novel requirement)

• Significant Economic Risk
  • Substantial Resources
  • If substantial uncertainty, because of economic risk, then such resources would be recovered within a reasonable period.

• Not commercially available
IRS regulations on internal-use software

• Final Regs. §1.41-4 (Oct. 4, 2016) Internal-use Software “IUS”
  • Clarifies high threshold of innovation test
    • Innovative – measurable improvement (speed improvement, cost reduction); no longer – unique and novel
    • Excludes software for use in 1) an activity that constitutes qualified research and 2) a production process
    • No “Revolutionary Discovery” required (Proposed)
• Explains & defines dual function software
• Includes examples of IUS and examples of the application of the process of experimentation
IRS Directive
ASC 730

• Provide IRS an efficient manner to determine QREs and more efficiently manage LB&I audit resources

• Who: LB&I taxpayers
  • Assets >=$10 Million and
  • US GAAP/Certified Audited Fin. Stmts.
    • Separate R&D line item on IS or in a Note

• Must Accept/Follow ASC 730

• Signed Certification Statement that Adjusted ASC 730 FS R&D as QREs
IRS Directive
ASC 730

• Certification Statement on Tax Return or at beginning of an IRC §41 exam
• Reconciliation of Form 6765 QREs to Adjusted ASC 730 Financial Statement
• Then IRS will not challenge claimed QREs.
• This Directive is not an official pronouncement of law, and cannot be used, cited, or relied on as such.
  • The IRS would be in favor of the Directive
IRS Directive
ASC 730

Taxpayer must determine if they want to follow this Directive

• Can they Comply? – Documentation supporting the detailed reconciliations

• Is it more beneficial to follow?
  • 95% of W2 Wages for qualified contributors and 1st level Supervisor Managers in ASC 730 CCs.
  • And the Lessor of 1) 10% of [above 95% Calc] OR 2) 10% Wages for Upper-Level Managers
  • No Contractor or Leased Computer costs included
  • Consider the related IRS Examination costs

• A Hybrid approach - Directive and §41 QREs?
  NO: One or the Other
III. Sampling and Allocation Methods for QREs

IV. Considerations for Small Businesses Claiming the R&D Credit

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Warner Robinson provides deep technical expertise in the area of R&D tax credits as our primary focus in assisting clients in documenting and supporting R&D tax benefits. Warner Robinson also serves real estate clients via green tax incentives around the 45L energy efficient home tax credit and the 179D energy efficient building tax deduction, as well as cost segregation studies. The company’s two founders, Bruce Warner and Cedar Robinson, have over 60 years of combined experience with the R&D credit as a former IRS attorney and Big 4 R&D practice leader, respectively.

Angelique Garcia is an experienced tax professional with over 10 years of experience managing and implementing R&D Tax Credit studies. She holds a B.S. In Chemistry from Rice University, and before entering the tax industry, she worked as a software developer in the energy sector.

As a Manager for Warner Robinson, Angelique utilizes her expertise and experience to prepare R&D credits that capture the maximum benefit to clients, as well as performing quality reviews to ensure that every study meets the highest possible standards for qualification and substantiation. Angelique has implemented hundreds of R&D studies for virtually every sector of software development, from healthcare, financial trading platforms and energy management to video game development and cloud computing. Although she specializes in software technology, Angelique has worked on studies for a wide variety of industries including chemical purification, manufacturing/fabrication, electrical engineering, apparel, healthcare, and others.
Allocation Techniques and Sampling in R&D Studies

Allocation - How to Allocate R&D Costs?
• Start with - what do the client’s records look like?
  • Taxpayer may have costs by project, or only costs by department or cost center
  • The company may or may not have a time tracking system
• IRS would prefer to see R&D costs by project but a cost center approach may be used IF there is a nexus between those costs and a qualified business component
Allocation Techniques and Sampling in R&D Studies

Allocating to Business Components - Cost Center Approach

- No prohibition against using a department or cost center method - See Briefing Paper on Taxpayer Approaches to Capturing Costs for the Research Credit IRS Pub. dated 5/24/2005
- First determine which departments have qualified activities
- Next which products or business components does that department develop?
- Have client (i.e., Dept Manager) allocate his/her department costs (i.e., wages of employees) to one or more business components for that year
  - This can be done via a survey or via interviews or combination
  - The department may already track spend across products for other purposes (which can be leveraged)
- IRS hot button issue is when taxpayer does not make any attempt to allocate the department’s costs to business component(s)
  - IRS position is supported in part by Bayer case (very difficult time with this issue and judge sided with IRS on one motion)
Allocation Techniques and Sampling in R&D Studies

- If the client doesn’t track hours, can have them complete a time survey to do this allocation - allocate employees to the appropriate business component
  - Line of cases allowing use of reasonable estimates (Cohan rule/case, Fudim, McFerrin, Union Carbide, Suder)
  - Estimates need to come from the employees/managers with first hand knowledge of the activities
  - Back up estimates with other supporting documentation:
    - Have manager review calendars, project timelines, launch dates, employee evaluations/reviews
    - Ideally time surveys are accompanied by interviews to ensure QRAs are understood and estimated percentages only include time to qualified projects

- Allocation should be done first before considering sampling (Bayer case)
- Key takeaway - allocations - lack of a time tracking system at your client doesn’t mean they can’t claim the R&D credit
Use of Sampling Techniques in R&D Studies

• Two uses of sampling:
  • Sampling to calculate qualified costs including extrapolating sample costs to other projects/departments to arrive at total QREs for the year
  • Sampling to determine which projects to document; client can calculate total QREs but needs to determine an approach to documenting qualified projects

• Two types of sampling:
  • Judgment sample
  • Statistical sample

• Two key IRS documents - authority for using sampling:
  • Rev. Proc. 2011-42 - statistical sampling
  • IRS Field Directive - use of sampling in research credit cases - pertains more to judgment sampling in R&D cases
Use of Judgment Sample

**IRS Field Directive on use of sampling in R&D cases**
- This paper states if the number of projects is very high, a true stat sample may still not be administrable; how to narrow down number of projects to review?
- Or if number of projects is too small and precision would not be sufficient, then use a judgment sample
- Taxpayer can also use these techniques in doing the R&D study
- Generally used for which projects to fully document; not commonly used for extrapolating dollars and arriving at total qualified costs (QREs)

**Steps Needed:**
- Goal is to document projects to achieve the greatest coverage of QREs claimed
- Can (and likely should) use strata - stratify based on like projects or like units
- Gather documentation, do interviews, prepare memos on largest projects in each strata
- Example:
  - Total population - 50 projects
  - Create 3 strata; pick top 5 largest projects in each of the three strata to document; assume this provides 85% coverage of all QREs
  - Last 15% of QREs? Could randomly pick projects using random number generator
- IRS audit would likely also focus on largest projects, so you have documented 85% of your biggest projects; some risk that IRS would pick some projects out of the other 15%, but those are only 15% of your QREs. Have taxpayer retain other documentation on these smaller projects.
Statistical Sampling in R&D Studies

• Stat Sampling under Rev. Proc. 2011-42
  • Following the IRS guidance in this Rev. Proc. allows taxpayers to use a stat sample when conducting the R&D study
  • Applicable to calculating R&D costs and extrapolating those costs to determine the total QREs and R&D credit amount

• Steps Needed:
  • Pick the sample unit:
    • Could be the employee, the project, the wage amount, job title, etc.
    • Could even have more than one sample unit if more than one strata (see below)
  • Create Strata:
    • Group similar items together; can stratify based on wage bands, project types, project size, job titles, criteria for qualifying (internal use in one strata, non-internal in second strata, supply costs separate from wage costs)
    • Results of each strata are typically applied to that strata only
    • Certainty strata - strata of largest projects which will be examined in full
    • Random strata - use random number generator program to randomly pick several smaller projects from random strata population
    • Extrapolate these results to rest of random population
Statistical Sampling in R&D Studies

- Define sample size for each strata:
  - Goal is to pick enough items to achieve a 95% confidence level (95% confident that the sample results reflect the rest of the population)
  - The lower the number of items selected, the lower the confidence level and higher the margin of error
- Apply results to population (Note: if relative precision exceeds 10%, taxpayer has to give back some of the sampling error)
Sampling Strategies in Multi-year Studies

• Many studies cover multiple years
  • Initial study - current year + three-year lookback
  • Years skipped due to carryforwards or lack of utilization
• Past - combine base years, sample study years individually
  • ASC - three base years
  • Regular method - 5-6 years in base population
Sampling Strategies in Multi-year Studies

- Current - study years can be combined
  - Bigger population overall = bigger sample, but fewer projects total than sampling each year individually
- ASC - up to 7 years in sample
  - 3 year base + up to 4 years of study
- Regular method
  - If startup before year 10 - combine base and study years
  - 80s base or after year 10 with gap - two samples
Sampling Strategies in Multi-year Studies

- Annual estimates and calculations still required
  - This has not changed
  - Results must be extrapolated per year
- Can achieve by stratifying by year
  - Strata (years) are estimated and sampled separately
  - Still allows annual sample sizes to be reduced compared to separate populations per year
- Precision must only be achieved over cumulative period
Precision in Statistical Samples

- Precision - describes how much an estimated value may vary
  - Influenced by many factors in stat sample
- Relative precision - how much an estimate may vary compared to its size
  - Expressed as percentage
  - Smaller is better!
- Statistical adjustment
  - Under 10% - no reduction
  - 10-15% - sliding scale
  - Over 15% - reduced by relative precision percentage
Example – Previous Method

• 100 projects per year
• 3 years of study
• ASC method

Base (3 yrs) = 300 projects = 40 sampled
Each study year = 100 projects = 30 sampled

40 + 3(30) = 130 projects to review!
Example – Current Method

- 100 projects per year
- 3 years of study
- ASC method

3 year base + 3 study years = 600 projects
600 projects = 60 projects to sample
Stratify by year - 10 projects per year

Sample size and effort cut in half!
Importance of Using a Qualified Statistician

Example formulas from Rev. Proc. 2011-42

\[
\hat{D} = N \overline{d} \quad \quad \quad \hat{X}_D = Y + \hat{D}
\]

\[
\hat{R}_C = \frac{\overline{x}_i}{\overline{y}_i} = 1 + \frac{\overline{d}_i}{\overline{y}_i}
\]

\[
b = \frac{\sum (x_{ij} y_{ij}) n^{-2}}{\sum y_{ij} n^{-2}} = 1 + \frac{\sum (d_{ij} y_{ij}) n^{-2}}{\sum y_{ij} n^{-2}}
\]

\[
b_c = \frac{N_i(n_i) S_{xyi}/n_i}{N_i(n_i) S^2_{yi}/n_i} = 1 + \frac{\sum (N_i(n_i) S_{xyi}/n_i)}{\sum (N_i(n_i) S^2_{yi}/n_i)}
\]

\[
S_{Rc_i} = \sqrt{\left[ \left( x_{ij}^2 / n_i \right) + \left( y_{ij}^2 / n_i \right) \right] + \left[ 2 \hat{R}_C \left( x_{ij} y_{ij} / n_i \right) \right] / n_i}
\]
Protecting Americans from Tax Hikes (PATH) Act of 2015

- December 15, 2015
- House amendment # 2 to a Senate amendment to H.R. 2029, Military Construction & Veterans’ Affairs and Related Agencies Appropriate Act of 2016
- 233 pages
  - § 143: Bonus depreciation for grafting nut & fruit bearing trees
  - § 166: Extension 7-year recovery period for motorsports entertainment complexes
  - § 335: Modification of the definition of hard cider
  - § 407: Termination of employment of Internal Revenue Service employees for taking official actions for political purposes
R&D Credit in the PATH Act

Title I - Extenders
Subtitle A - Permanent Extensions
Part 3 - Incentives for Growth, Jobs, Investment, and Innovation
Sec. 121: Extension and modification of research credit

- § 121 Subsections
  (a) Made Permanent
  (b) Credit Allowed Against Alternative Minimum Tax in Case of Eligible Small Business
  (c) Treatment of Research Credit for Certain Startup Companies
  (d) Effective Dates
PATH Act - § 121 Subsection (a)

- The R&D Credit was first codified in the Economic Recovery Act of 1981

- Written to be temporary, but continuously renewed 18 times except for one-year lapse in 1995

- The PATH Act strikes the temporary provisions of § 41, making the R&D credit permanent

- Easier to include in financial planning
Alternative Minimum Tax (AMT)

• Purpose: ensure high-income individuals pay more tax than they otherwise might
  – Corporations
  – Individuals earning roughly $180k+ per year

• Reimposes tax on tax-exempt income and denies certain credits & deductions

• Form 6251
PATH Act - § 121 Subsection (b)

R&D Credit as AMT Offset

• “Credit allowed against alternative minimum tax in case of eligible small business (ESB)”

• ESB - average of less than $50MM in gross receipts over prior three tax years
PATH Act - § 121 Subsection (b)

R&D Credit as AMT Offset

- C-Corps
  - Can qualify as ESBs
  - Benefit directly

- Shareholders, Partners of S-Corps or Partnerships
  - Each must separately be below the gross receipts threshold to offset personal AMT
  - Benefit indirectly - R&D credit lowers entity taxable income, resulting in a higher pass-through benefit
PATH Act - § 121 Subsection (c)

R&D Credit as Payroll Tax Relief

- “Treatment of Research Credit for Certain Startup Companies”

- “Certain Startup Companies” = Qualified Small Businesses (QSB)
  - Gross receipts in credit year less than $5MM
  - No gross receipts prior to the five-year period ending in the year of the current claim
  - So if claiming for 2019, first year must be 2015 or later
PATH Act - § 121 Subsection (c)

R&D Credit as Payroll Tax Relief

• Federal Insurance Contributions Act (FICA)
  – Social Security (OASDI) - 6.2% of gross wages
  – Medicare (HI) - 1.45% of gross wages

• Limitations
  – $250k limit per year
  – Not refundable - credit cannot exceed tax
  – Unused credits may be carried forward to the next quarter
PATH Act - § 121 Subsection (c)

R&D Credit as Payroll Tax Relief

• Form 6765 Sec D - timely filed return (including extensions)
  – Line 41: “Check this box if you are a qualified small business electing the payroll tax credit.”
  – Line 42: “Enter the portion of line 36 elected as payroll tax credit (do not enter more than $250,000).”

• Credits begin to be claimed against payroll taxes owed in the first quarter after the tax year for which the 6765 was filed
PATH Act - § 121 Subsection (c)

R&D Credit as Payroll Tax Relief

• Form 941 (filed every quarter)
  – Line 11: “Qualified small business payroll tax credit for increasing research activities”
  – Line 12: “Total taxes after adjustments and credits”

• Form 8974 - NEW
  – Asks a few basic questions about the return
  – Determines the credit that can be used each quarter
  – Attached to Form 941 that quarter
PATH Act - § 121 Subsection (d)

Effective Dates

• Changes imposed are effective after December 31, 2015

• Tax year 2016 and beyond - remember, this is PERMANENT!
How to Plan

• Determine eligibility based on 4-part test

• Get an estimate of the size of benefit

• Discuss procedures with your PEO if claiming payroll credit

• Work with an expert to document and substantiate qualified projects and costs
Summary

• More companies qualify for the R&D Credit than you might think

• The PATH Act significantly strengthened the R&D Credit for both larger, more established companies and young startups

• The time to plan is now!