

The background of the slide is a top-down photograph of a workspace. It features a silver laptop with a trackpad, a white computer mouse, a pair of white earbuds, and a white cup of coffee with a dark liquid inside. A blue rectangular overlay is positioned on the left side of the image.

VIRTUAL COFFEE TALK

Insights into the Changing R&D Landscape

Kevin M. Jacobs and **Kathleen King**, Alvarez & Marsal Taxand
Kevin DeYoung, Wolters Kluwer

January 24, 2022 | 1:00 to 2:00 p.m. ET



Wolters Kluwer



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Agenda

- 1 Planning for Section 174 Capitalization
- 2 New Guidance for Research Credit Claims
- 3 Updates on Recent and Pending Research Credit Cases
- 4 Current Trends in IRS Audits

Planning for Section 174 Capitalization



Legislative Outlook

BUILD BACK BETTER ACT

TAX EXTENDERS

Summary of Upcoming Changes to Section 174

- This revenue raiser from TCJA requires research and experimentation (“R&E”) expenditures to be capitalized and amortized
- Effective for tax years beginning on or after January 1, 2022, amortization period is —
 - 5 years for R&E performed in the U.S.
 - 15 years for R&E performed outside the U.S.
- Awaiting further guidance, but it is likely an accounting method change that will require a Form 3115
- Software Development costs deemed to be section 174 expenditures
- The deduction is not accelerated even if the property is sold or abandoned



POLLING QUESTION

Do you think that Congress will revert to the pre-TCJA standard for section 174 costs?

- ☐ **Yes, but it won't happen until late 2022**
- ☐ **No, I think amortization is here to stay**
- ☐ **No, I think it will be deferred again before the end of 2022**
- ☐ **Not a complete reversal, but changes will be made**

Leverage Research Credit Workpapers for Section 174



ADDITIONAL ACTIVITIES

- Foreign*
- Internal Use Software
- Funding

** Foreign research will need to be separately tracked.*



ADDITIONAL EXPENSES

- Salaries, Non-Taxable Benefits and Fringe
- Materials, Facilities, and Equipment Costs
- Indirect Costs

Identifying Section 174 Expenditures

Key Area of Focus

What types of expenses must be included?



**SECTION 174
REGULATIONS**



**INFORMAL IRS
GUIDANCE**



**LEGISLATIVE
HISTORY**



COURT CASES

Identifying Section 174 Expenditures *(cont'd)*

Key Area of Focus

What makes an expense “incident to” research?



**DIRECT
v.
INDIRECT**



**RESEARCH
v.
PRODUCTION
v.
MARKETING**



**TIMING
AND
IMPACT**

Reminder on Other Conforming Changes



- Effect on other TCJA provisions (especially those limited or determined based on taxable income)
- Adjustment to section 280C(c)
- Impact on state research credits (especially those that apply section 174 definition)
- Potential accounting method changes
- Section 174 has been added to the IRS Priority Guidance Plan

New Guidance for Research Credit Claims



Chief Counsel Memorandum 20214101F

- On October 15, 2021, the IRS released a Chief Counsel memorandum on R&D credit refund claims
- The memorandum intended to identify the information that is necessary in order to be considered a valid refund claim
- Effective for any claims filed on or after January 10, 2022



What is a valid claim?

- Treas. Reg. Section 301.6402-2(b)(1) requires a refund claim must “set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof”
 - Specificity
 - Valid or deficient
- Research credit court cases addressing validity of claim:
 - U.S. v. McFerrin
 - Harper v. U.S.
 - Intermountain Electronics v. U.S.
 - Premier Tech v. U.S.



Minimum Requirements for Valid R&D Credit Claim

- Identify all the business components to which the IRC Section 41 research credit claim relates for that year
- Identify for each business component:
 - All research activities performed
 - All individuals who performed each research activity
 - All the information each individual sought to discover
- Provide the total qualified employee wage expenses, total qualified supply expenses and total qualified contract research expenses for the claim year (this may be done using Form 6765, Credit for Increasing Research Activities)

New FAQs Address Requirements for Claims

- In early January 2022, the IRS released FAQs for research credit refund claims outlined in an October 2021 chief counsel memorandum
- Starting January 10th, taxpayers must provide substantial information for a research credit claim on an amended return to be deemed “valid” — which means it provides sufficient information — before the IRS will consider the claim
- FAQs expand on the IRS’s internal procedural guidance released earlier this week, but also raise additional concerns for taxpayers trying to navigate through the claim submission process

Clarifying Guidance in FAQs



- Groups of individuals may be listed together who worked on research activities seeking the same information
- Taxpayers may identify the individuals by title or position in lieu of providing specific names, although the names may be required upon substantive review of the claim
- The IRS plans to “expeditiously” review research credit refund claims and make determinations within six months of receipt

Clarifying Guidance in FAQs *(cont'd)*



- Taxpayers may be surprised to learn that for a refund claim that includes other items, if they do not perfect the research credit claim within 45 days during the one-year transition period, the entire refund claim will be rejected
- Taxpayers may want to consider filing two different refund claims to avoid the non-research item from being tied up in a potentially lengthy review process or rejected along with the research claim

Public Comments on CCM

- ABA believes the claims guidance should be part of a regulatory process because field attorney advice is nonauthoritative guidance and likely to be challenged in the courts
- NAM believes that the rules would impose significant new burdens, create uncertainty, and hurt the ability of taxpayers to file a valid refund claim



POLLING QUESTION

Do you believe that your workpapers are sufficient if your research credit is audited?

- ☐ **No, the changing IRS requirements make it difficult**
- ☐ **Yes, we are very diligent in our review and documentation process**
- ☐ **Yes, but we expect the IRS will review them carefully**
- ☐ **Maybe, but it's hard to gauge with the ever changing IRS guidance**

Update on Recent and Pending Court Cases



Update on Recent Court Cases



**CONTRACT
RESEARCH**



**BUSINESS
COMPONENT**



**PROCESS OF
EXPERIMENTATION**



DESIGN AND STYLE

Update on *Little Sandy Coal v. CIR*

- Tax court case docketed on 11/17/2021
- Briefing Schedule:
 - Appellant's (LSC) brief: due on or before 03/24/2022
 - Appellee's brief (CIR) due on or before 06/10/2022
 - Appellant's reply brief, if any, is due on or before 07/13/2022

Current Trends in IRS Audits





POLLING QUESTION

Would you like to be contacted by A&M to discuss your company's R&D expenses and credits?

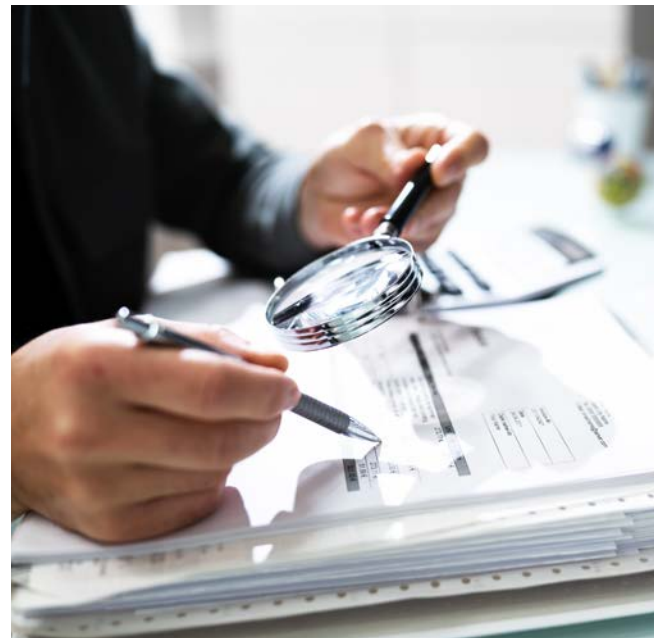
- ☐ Yes
- ☐ No
- ☐ Not applicable

Disputes Likely to Continue



Seen in the Field — IRS Audit Techniques

- Increasing focus on Section 174 expenditures
- *Little Sandy Coal* IDRs
- Stat Sampling in IRS Audits
- State Audits of Research Credits on the Rise



CCH[®] AnswerConnect



POLLING QUESTION

Would you like a more in-depth demo or further details on the resources and tools available on CCH® AnswerConnect?

☐ Yes

☐ No

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Thank you for attending

Virtual Coffee Talk — Insights into the Changing R&D Landscape

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Kevin M. Jacobs

Kevin M. Jacobs is a Managing Director with Alvarez & Marsal Taxand in Washington D.C. and the National Tax Office Practice Leader. He brings more than 15 years of experience in tax matters in both the public and the private sectors.

Prior to joining A&M, Mr. Jacobs was a Senior Technician Reviewer (TCJA) with the IRS Office of Associate Chief Counsel (Corporate) for more than six years, where he advised on tax issues such as corporate re-organizations and corporation-shareholder issues, earning and profits, recovery and allocation of stock basis, liquidations, redemptions, bankruptcies, spin-offs and consolidated returns.

Mr. Jacobs was the principal Associate Chief Counsel (Corporate) attorney on several regulatory projects including the proposed section 382(h) regulations on built-in gains and losses, the global intangible low-taxed income regulations, and debt-equity regulations. He provided substantial contributions to numerous other guidance projects, such as the limitation on interest deductions regulations, and assisted in overseeing the Corporate Division's response to TCJA, including the coordination with Treasury's Offices of Tax Legislative Counsel and International Tax Counsel. Previously, Mr. Jacobs spent more than nine years at law and certified public accounting firms (Ropes & Gray LLP, Latham & Watkins LLP, Dewey Ballantine LLP and Arthur Andersen LLP).

Mr. Jacobs earned a bachelor's degree in accounting, a master's degree in accounting (with a concentration in taxation), a J.D. (magna cum laude) from the University of Florida and an LL.M. in taxation from New York University. He is admitted to practice before multiple courts, including the Supreme Court of the United States, the U.S. Tax Court and the U.S. Court of Federal Claims. He is admitted to the District of Columbia and Florida Bars and is a licensed Certified Public Accountant (CPA) in Florida and Colorado. Mr. Jacobs is a member of several organizations including the American Bar Association and the New York State Bar Association. He is also a frequent speaker on numerous corporate transaction tax matters.

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Kathleen King

Kathleen King is a Managing Director and National R&D Practice Leader with Alvarez & Marsal Taxand in Washington, D.C. She specializes in assisting clients in the process of claiming, domestic production deductions, documenting and sustaining tax incentives, including research tax credits, domestic production deductions, meals and entertainment deduction, and fixed asset treatment.

With more than 25 years of experience, Ms. King's projects have ranged from targeted consulting engagements designed to address specific issues to large-scale projects utilizing engagement teams working concurrently in multiple locations. She has extensive experience in leading research credit analyses and representing her clients in audits performed by the Internal Revenue Service and state tax authorities at the field and appeals levels.

Ms. King has worked with clients across various industries, including aerospace and defense, food products, manufacturing, pharmaceutical products, retail and software.

Prior to joining A&M, Ms. King was a Senior Manager at KPMG, where she served as a national resource for the Research Credit Services team. Previously, she was a member of Arthur Andersen's national Research Tax Incentives team.

Ms. King earned a bachelor's degree in mineral land management from the University of Colorado and a master's degree in accounting from American University in Washington, D.C. She is a Certified Public Accountant (CPA).




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