



# UHY Executive Briefing

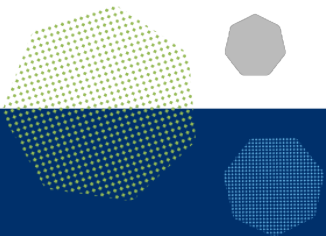
Understanding The Latest Changes To R&D Tax Credits

*October 19, 2020*

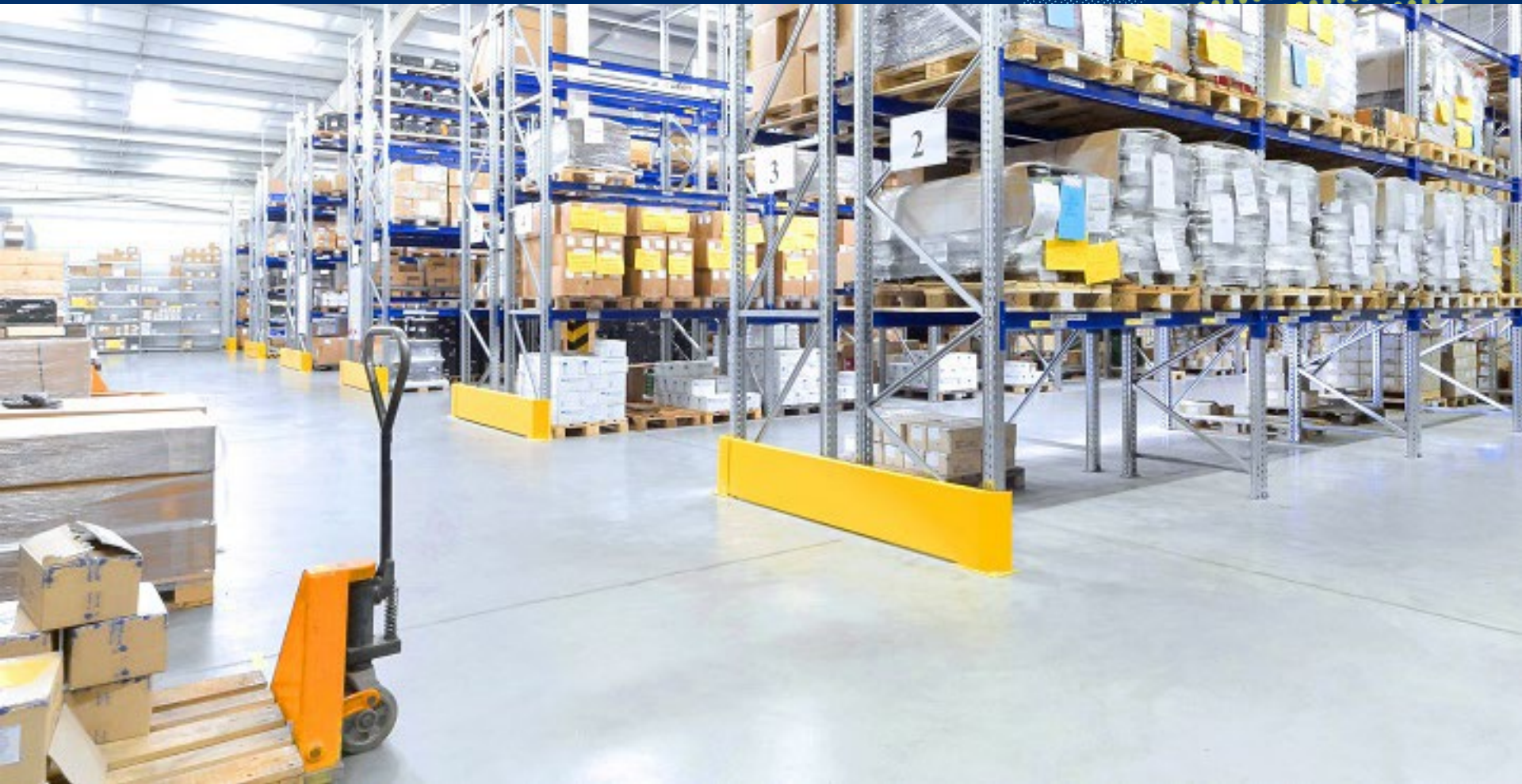


# UHY National Tax Services, Inc.

- National Practice
  - R&D Tax Credit
  - Cost Segregation
- 25 years experience in Section 174, 41 focus
- Engineering resources located across country



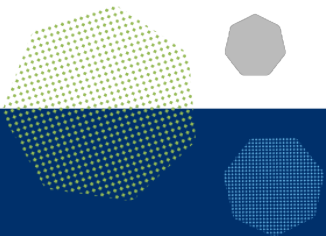
# Real World Results



# Third Party Logistics

## Specializing in Forward and Reverse Logistics

- The people and processes inside the building
- Staff of Industrial Science Engineers
- Process Driven
  - Continuous Improvement
  - Lean / Six Sigma
  - 5S
  - Automation



# Original Approach

## Project Approach / Focus

- Very project driven
  - Aligned employee time/costs to the project
  - Aligned each supplier invoice or subcontractor to the project
- Spent many hours developing narratives and justifying the projects
  - Service attacked and disallowed entire projects

***RESULT: Approximately 65% of claim denied***



# Revised Approach

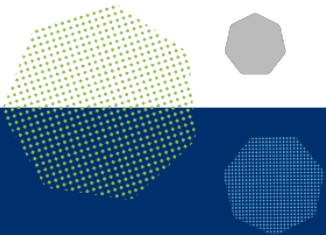
## “Business Component” Approach

- Looked at the Department’s/Employees involved in R&D Activities
  - How much time is devoted to R&D activities vs other activities
  - What supplies do they consume
  - Do they hire subcontractors to help with R&D activity
- Tie employees to the process of R&D rather than projects

***RESULT: Larger claim – and approximately 5% denied on audit***

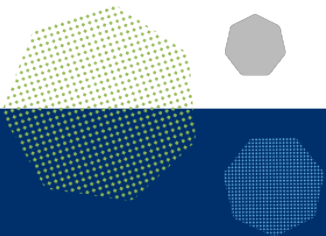
# Polling Question #1

- Has your company ever had its R&D tax credit claim audited by the IRS or state?
  - Yes
  - No
  - What is an audit?
  - N/A



# Recent Developments – IRS Side

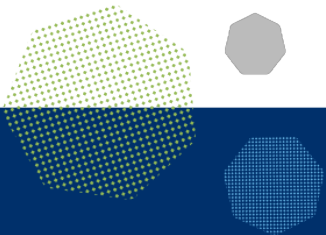
- IRS views R&D tax credits as an extreme resource intense issue
- Limited resources – where to commit?
- Expectation of taxpayer to demonstrate compliance with statute (4-part test)
  - Taxpayer burden of proof
  - Activity based analysis vs. financial analysis





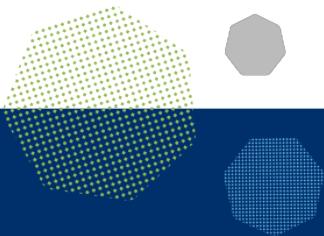
# Recent Developments – IRS Side

- IRS initiatives
  - Goal is to properly deploy limited resources
  - Deselect areas of minor concern
  - Established Risk Review Team (SMEs) to assist field
  - Established “issue” campaign
    - E.g., 174 expanded definition (Pilot Model regs)
  - SBSE Division consolidated resources under common leadership umbrella
- IRS Appeals



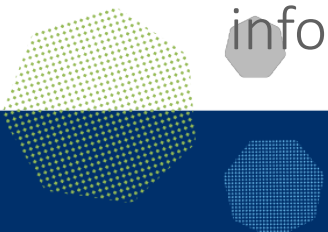
# Recent Developments – “Business Component” Focus

- New LB&I emphasis on “business components”
- IRC Section 41(d)(2)(A) states that [the 4-part test] shall be applied separately with respect to each business component of the taxpayer
  - Not at the level of the employee, taxpayer or project level
- What is a “business component?”
  - Expansive definition including any product, process, computer software, technique, formula or invention associated with trade or business



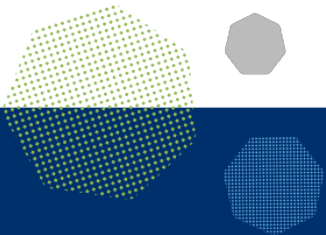
# Recent Developments – Business Component

- FAA 20214101F (Sept. 17, 2021)
- Refund Claims
  - Beginning 1/10/22 taxpayers claiming refund on amended return must identify all business components to which the claim relates
  - All research activities performed
  - All individuals who performed the activities
  - All the information sought to discover
- Goal is to provide greater understanding of reason and rationale for claim
- Eliminate agency assigning resources where not needed
- \*\*\*Audits of original filed returns asking for similar information



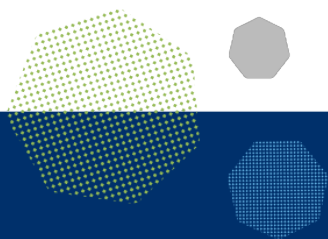
# Recent Developments – Business Component

- Practical compliance challenge
- Most taxpayers have cost center-based accounting systems (SAP, Oracle based) and don't capture activities & expenses on business component basis
- IRS and Treasury recognize that the R&D tax credit can be burdensome for the taxpayer (December 2001 regs)
- 20 years later



## Poll Question #2

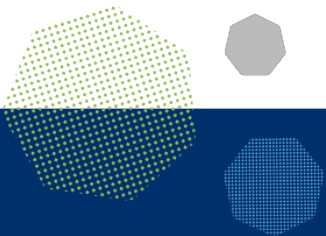
- How often do you review your R&D support to confirm it is IRS ready based on most recent guidelines?
  - Annually
  - Every couple of years
  - Unsure
  - We don't claim the R&D credit



# Recent Developments – Business Component

What do you do?

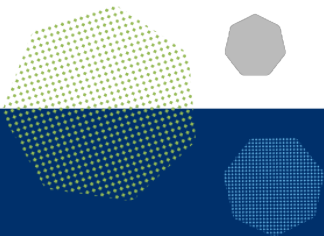
- Project Accounting
  - Often results in understated credit
  - Can be resource intensive, annual restart
  - Difficult to persuade IRS of statute compliance [4-part test]
    - Fact sensitive
    - Shifts burden to IRS to understand IP
    - IRS applies exclusions first



# Recent Developments – Business Component

What do you do?

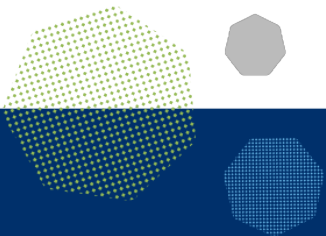
- Stand your ground
  - Congress intended eligibility should not be unreasonable on taxpayer
  - Congress intended to allow taxpayer broad flexibility in methodology to claim credits
  - *Suder v. Commissioner* approved allocation methodology and rejected governments assertion requiring direct nexus between costs and activities



# Recent Developments – Business Component

## Best Practices

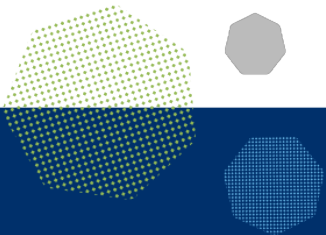
- Avoid using flowery descriptions
- Avoid using bad buzz words (“maintenance”, “debugging”, “simple”, “routine”)
- Avoid presenting volumes of binders
- Create a matrix of contemporaneous documentation as it relates to the 4-part test
- Be prepared and organized





# Poll Question #3

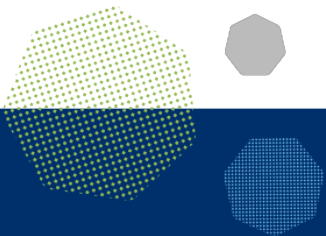
- Do you feel that the R&D tax credit program is too burdensome or not worth claiming?
  - Yes
  - No
  - We don't have R&D activities



# Recent Developments – Business Component

## Case Study Example

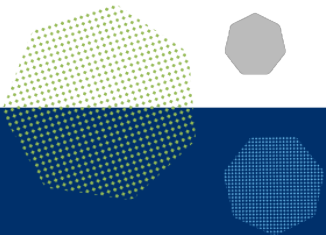
- Window company with 400 engineers
- Previous R&D claim was fully denied by IRS, where:
  - 400 questionnaires completed by engineers
  - 250 project narratives
  - Confusing compilation of contemporaneous documentation
- Taxpayer & IRS agreed to informal methodology review for next year claim
- 2-day visit with IRS (territory manager, case manager, multiple engineers)



# Recent Developments – Business Component

## Case Study Example

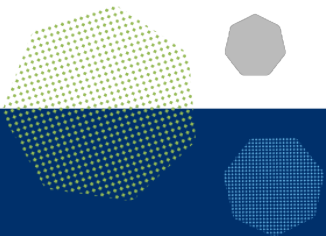
- Scrapped questionnaires and intrusive level of taxpayer involvement
- Business Component Framework
- Identified 18 different Business Component Activity Groupings
  - E.g., Innovation, R&D, Product Development, Commercialization, Continuous Improvements, etc.
  - Estimates for R&D time
  - 10 to 1 ratio for SME to provide estimates of employees



# Recent Developments – Business Component

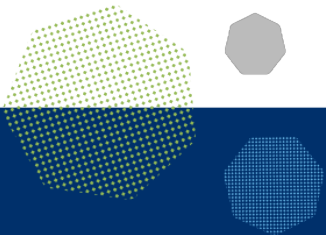
## Case Study Example

- IRS requested other audit examples of this approach
- Provided valuable feedback
- Approved methodology
- 97% sustainment under final exam



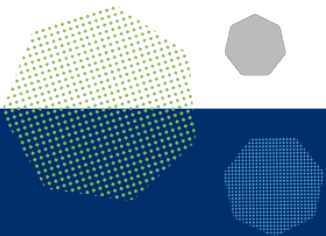
# Recent Developments – 174 amortization

- Starting in 2022 R&D costs must be put in capital account and amortized over 5 years (U.S.)
- Section 174 has broad definition
  - Section 41 credit is more limited
- Still possibility of legislative fix
- But expensive and benefits corporations, not individuals



# Poll Question #4

- Have done any planning for the Section 174 amortization requirement?
  - Yes
  - No
  - N/A

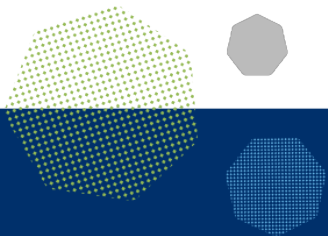


# About UHY

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