

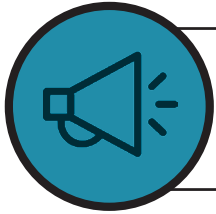
ROUNDTABLE WHITE PAPER

WEDNESDAY, MARCH 8, 2023

TEI PORTLAND
CHAPTER + MASSIE
R&D TAX CREDITS



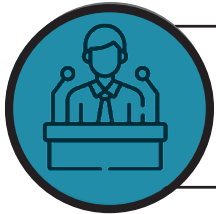
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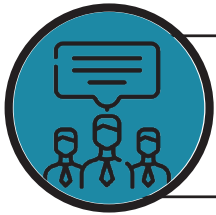
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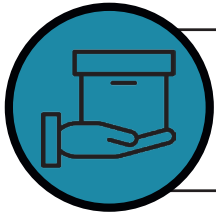
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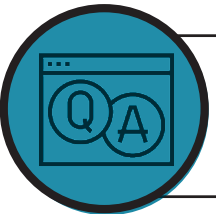


Section 174

Panel Speakers

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Companies Who Attended

Aequitas Capital Receivership
Cambia Health Solutions
Columbia Helicopters
Columbia Sportswear Company
CorVel Corporation
Daimler Truck North America LLC
Flint Group
Form Factor
Fortive Corporation
Hampton Lumber
Infinera
KinderCare Learning Companies
Klarna
Lattice Semiconductor
Mars Inc.
Nautilus Inc.
NIKE
NW Natural
Ocean Oil Construction and Services
Oregon Tool
Oregon Tool, Inc.
Papa Murphys
PGE
Powin
Precision Castparts Corp.
QORVO
Redesign Health
Roseburg
Schnitzer Steel Industries
Standard Insurance
Tektronix
TrueCar, Inc.
Weir Group Inc.



MASSIE Notes



Introductions and Announcements

Jason Massie and Peter Green, *MASSIE R&D Tax Credits*

- MASSIE is a 2023 Platinum TEI Sponsor. We look forward to seeing some of you at the March Midyear TEI event in DC.
- If you will be at the TEI Region 9 Conference in Bellevue, WA in May, stop by our table to say hi.
- Thank you to **Walt Benz** and **Brigette Mercer** for allowing MASSIE R&D Tax Credits the opportunity to host our Roundtable on the Road for the TEI Portland Chapter.



Jason Massie



Peter Green



R&D and the Art of War

Jason Massie, *MASSIE R&D Tax Credits*

- In 500 BC, military general Sun Tzu wrote a 13-chapter treatise describing aspects of war. Today, these strategies are studied and applied to tactics ranging from battle to football. Tzu famously said, “Every battle is won before it is fought,” prompting his readers to attack weakness and utilize strengths.
 - R&D is all about the preparation. Clients own their stories, and therefore have to share it with the IRS in a concise, calculated way.
- Taxpayers need “reasonable flexibility” in the way they substantiate their credits.
 - Congress has stated, “eligibility for the credit is not intended to be contingent on meeting unreasonable record keeping requirements.”
 - Section 41(b) and Treas. Reg. section 1.41-2, re: QREs do not explicitly require substantiation at the business component level
 - So, how do we design studies to meet these requirements and comply with regulations?



Jason Massie



- In 2016, the LB&I Reorganization prompted the hiring of more agents and the adoption of a campaign-style approach to tax credit studies, indicating that the IRS was going on the offensive to attack weaknesses within claims.
- When the credit was made permanent in 2015, this opened up the flood gates of scrutiny because every firm wanted to help identify and document the tax credit claim. As a result, the IRS couldn't handle the high volume of refund claims. Subsequently, during the COVID pandemic, remote review of paperwork was required—an aspect that put the IRS further behind.
- What's going on with the credit now?
 - The IRS is looking for ways to curb taxpayers' enthusiasm for claiming credit or filing refund claims, beginning with making contemporaneous documentation requirements stricter. Beginning in 2021, taxpayers also had to identify all business components and activities for refund claims.
 - If taxpayers did not comply with these new requirements, their claims were put into a rejection pile and granted only a specific period of time afterwards to supply the required information—an offensive move from IRS.
 - Further, the IRS enacted SME witness interviews akin to a deposition. These interviews are used to pose tough questions, confuse the engineer, or challenge them with questions unrelated to a project in which they were involved.
- Potential change to 6765
 - Changes include list of entities, business activity codes, and new categories of QREs.
 - Additionally, the IRS is now requiring attachments—specifically disclosing data within in a form with limited characters.
- What does this change mean for R&D tax credit claims?
 - Campaigns are still largely data driven, but the IRS is shifting from a transparent and collaborative approach to one more adversarial in which they go directly to witness interviews.
- Advice going forward
 - Be proactive in identifying business components.
 - Ensure SMEs are comfortable with impromptu IRS interviews regarding their activities.
 - When an audit occurs, move quickly. Make sure adequate documentation has been gathered.
- Pitfalls to avoid
 1. Choose wise representation
 - Get involved in your own study and take on this task internally. Use a vendor to help, but make sure they issue reports in a timely manner (preferably reports in Excel so that they can be manipulated—not just PDFs.)



2. Bias against narratives
 - Avoid boiler plate responses. Dig into the details, ensuring that overworked, “canned” phrases don’t result in red flags for the IRS.
3. Missing contemporaneous documentation
 - Failure to provide support for innovative activities is damaging to the claim. Educate SMEs on how to bake in processes that support the R&D credit into their daily activity.
4. Broadly defining project “families”
 - Learn how to group large numbers of projects into digestible segments for the IRS.
5. Lack of support from employees
 - Information must be a result of direct knowledge. Are managing SMEs being required to speak to every project/employee? Make SME groups smaller, create executive level questionnaires, and attack the higher salary brackets.
6. Failure to train and prepare SMEs
7. Support for credit is not logically organized
 - Make sure documentation and narratives are consistent



Leveraging Technology

Peter Green & John Hoang, MASSIE R&D Tax Credits

- Telling the story behind research activities. What are the tools to use? Focus on SME user experience and tax department visibility and control. SMEs are busy, so make the process easy, concise, and transparent.
- After studying over 200 of America’s top companies, what have we found to be the best practices for the R&D tax credit?
- Old Style vs Gold Standard
 - Old Style - Interviewing, taking notes, and translating these transcriptions into a report. Unique stories for each SME start to sound similar because a tax employee wrote the report.
 - Gold Standard – After training SMEs on simple, step-by-step instructions to provide the data, allow them to use their own technical language at the required level of details to create the final technical interview report.
- Architecture Phase
 - Locate and learn about SMEs at a company.
 - Find existing systems that can provide data commonly requested from the SME.
 - Find the optimal interaction methods based on SME preference (email, Teams, Zoom, etc.)
 - Conduct user experience testing on trusted SMEs to get their feedback on the provided workflow
 - Agree on project plan/timeline and provide sample answers and documentation mapping



Peter Green



John Hoang

- Teams Demo – A collaboration hub designed to quickly and efficiently interact with SMEs
 - Introduce the credit and why they've been selected as an SME
 - Share educational materials and give the SME the opportunity to schedule a follow-up training session
 - Using the R&D portal to complete info requests, the SMEs can be integrated within Teams in a customizable way
 - There are buttons to schedule meetings, instructions on the questionnaire, and a guidebook that offers step-by-step assistance throughout the process
 - Response boxes for 4-part test allow SMEs to attach documents directly. This data is collected behind the scenes in secure SharePoint site.
 - When the SME clicks submit, it generates a task within Teams to be reviewed by the credit consultants.
 - The Teams portal allows users to track SME tasks, scheduled due dates, and check the status of projects.
 - Using PowerBI dashboards, tax consultants can see data by job title, department, state, wage, SME response rate, etc.
- In the future, many companies are considering adding AI machine learning to review and rank questionnaires based on keywords and other criteria—an effort slated to streamline the review process altogether.

Section 174



Alex Sadler, Morgan Lewis

Peter De Nicola, Fujifilm; Robert Howren, Aveanna Healthcare; Blake Udall, McAfee; Katrina Welch, Past TEI International President

Jason Massie, MASSIE R&D Tax Credits

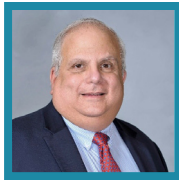
- What are 174 Expenditures?
 - Development is no longer under the 174 umbrella once uncertainties are faced.
 - “All costs incident to the development or improvement of a product.” Reg. 174-2(a)(1) Development activities are product and software development, process research, prototypes, and pilot models. Expenditures are wages, supplies, contractors, and patent fees.
 - Indirect costs are overhead-related, utilities, rent, depreciation, etc.

- No new regulations, court opinions, or IRS rulings. New section 174 has taken center stage, as amendments under PCJA are creating angst for taxpayers.
- Section 174 Update
 - Legislative outlook is cloudy. The notion of R&D being a worthwhile area for investment has bipartisan support, but it is expensive and benefits corporate America—a fact that could be deemed controversial compared to other initiatives.
 - Procedural guidance: How to switch accounting method for R&D expenditures. Rev. Proc. 2023-11 provides for an automatic change in method of accounting to the required section 174 treatment.
 - For the first tax year in which amended section 174 is effective, taxpayers may file a statement with their original return in lieu of Form 3115.
 - In subsequent years, the taxpayer must file Form 3115 with a modified section 481(a) adjustment accounting only for specified R&E expenditures in post 12/31/21.
 - Regulatory guidance is forthcoming, but the timing remains unclear.
 - Congress is kicking the can down the road, and it is currently unclear as to what issues will be tackled and when.
- Credits create value, as companies are risking resources for US development. This stimulates economy, retains employees, and encourages green technology.
 - Thorny issues
 - Expenditures by contractors are under cost-type contracts.
 - Conforming amendments to section 280C(c).
 - Quantifying specified R&E expenditures.
 - Costs of R&D services under cost-type contracts
 - R&E - Nature of activities, potential IP retention.
 - Not R&E - Lack of economic risk, integral to the tax credit, service provider vs. true developer, Section 41 treatment, and FAS treatment.
 - Section 280C(c)(1) Post TCJA Amendments
 - Before, it was clear that taxpayers could take deductions and reduce them by amount of the credit.



Alex Sadler

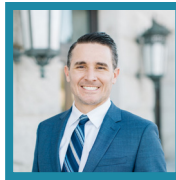
- A new statute says that if the amount of credit determined for the taxable year under section 41(a)(1) exceeds the amount allowable as a deduction for such taxable year for qualified research expense or basic research expenses, the amount of chargeable to capital account for the taxable year for such expenses shall be reduced by the amount of such excess—ultimately a taxpayer-favorable result.
- Draft revision to Form 6765
 - Similar to prior except if filing a refund claim on amended return rather than new, there are more requirements (i.e. itemize each BC, identify individuals, what they were doing/seeking.)
- IRS Update - Schedule UTP
 - IRS wants more detail on the nature of issue and research, as this helps to allocate audit resources.
-



Peter De Nicola



Robert Howren



Blake Udall



Katrina Welch

Tips and Takeaways from the Panelists

- Evaluating how General Ledger balances roll-up, applying a reasonable 174 percentage to those amounts, and ultimately applying a book tax difference to come up with what we deem as a 174-amortizable expense for the year.
- Important to ensure cost centers are neat and tidy, establishing a structure that taxpayers can rely on as it relates to cost centers.
- Important to understand which companies are incurring charges and how to report them.
- Exploring a practical approach versus a full study. Evaluating ratios of QREs from a study to figure out what percentage might be realistic.



174 Summary

1. Basics of Section 174 Capitalization
 - Required to capitalize and amortize all costs “incident to” research for tax years beginning after 12/31/2021. 5 years US, 15 years foreign.
 - No write-off for abandoned or disposed 174 capitalized costs.
 - All software dev is now included as 174.
 - 174 Capitalized amount creates a deferred tax asset, which can impact 163(j) interest cap, GILTI, and FDII.
 - 174 includes R&D costs in the experimental or laboratory sense.
 - Expenditures related to activities to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available does not establish the capability, methodology, or appropriate design of the product.
2. Costs Incident To Research
 - DIRECT COSTS OF RESEARCH: In-house wages, supplies, computer rental, cloud computing, third-party contractor payments.
 - INDIRECT COSTS OF THE RESEARCH: other salaries, utilities, materials, supplies, depreciation, overhead
 - COSTS EXCLUDED FROM 174:
 - Ordinary testing
 - Efficiency surveys, managerial studies, customer surveys
 - Advertising or promotion
 - Acquisition of patent, model, production or process
 - Research related to literary, historical, or similar projects.
3. Various Methods to Calculate 174
 - Review Section 41 workpapers
 - ASC 730 financial statement R&D
 - Rev Proc 2000-50 computations for software
 - MASSIE’s approach is to start with R&D Section 41 workpapers and ADD TO that number for various adjustments.
 - If you start with ASC 730, then you will likely be SUBTRACTING from that number to convert to Section 174.
 - IRS will likely want to see a multiple of your Section 41 starting place.
 - We are seeing lower multiples for software companies than for manufacturing.



4. Things To Consider

- The IRS will likely look at your capitalized Section 174 when reviewing your Section 41 claim. So don't under-capitalize "core" R&D costs as it will adversely impact your R&D credit.
- Some states have differences in treating 174 versus federal.
- Rev Proc 2023-11 states this is an automatic method change, requires a statement rather than 3115.
- Contractor relationships can be tricky.
- Closely analyze foreign activities with your group and CFCs.
- Accounting firms are coming up with different positions for certain items
- Make sure you have a logical way to allocate your indirect costs.

Research Credit, the IRS, and Interactions

Mike Gregory, Michael Gregory Consulting



Mike Gregory

- How to address regulations with innovative storytelling based on scientific method.
- Engineers are often more excited about what efforts worked, so they don't fully document failures.
- Must haves
 - Provide description of business components
 - Provide examples of technical uncertainties and accompanying variables
 - Provide sciences used during the process of experimentation
 - Provide specific examples, testing in relation to project
 - Provide supporting documents that exist in relation to project—specifically paired with calendars and time sheets rather than estimates
- Statistical Sampling
 - How to sample 15,000 projects? The IRS will work with you (Letter of Understanding.)
 - For example, gather a stat sample of 1000 project, then whittle down to 80.
 - This has to be approved by the IRS, so ensure effective communication during this process.
- Key Players at the IRS
 - Case Manager – Oversees overall audit



- Team Coordinator – The day-to-day agent
 - Learn all you can about them, relate to them, and seek to create an authentic connection.
 - Send personal emails. Know what is going on in their personal life.
 - As humans, we are emotional first, fair second, and then rational.
- Team Member - Works for the coordinator
- Engineering manager
- Engineer
- Computer Audit Specialist Manager (CAS)
- CAS
- Industry Practice Network

- Start of the Audit – Questions to consider
- Who are the key players of this audit? What are their intentions? Would they like info on how our study was done? Are their projects they want to focus on? What can we do in the future? Are they interested in a judgement sample, stat sample? Do we need a Letter of Understanding?
- How info document requests are expected to flow
 - Talk about the draft of the IDR, make sure it is clear, and determine what info will ultimately be requested.
 - Ensure that the IDR uses clear/concise language that suits the department.
 - Once a draft is agreed upon, discuss a timeframe for a response to the IDR.
 - Create a reputation for trust and honesty with IRS agents.
- Understanding how the IRS rates employees
 - Five job elements - Each job element has three performance aspects
 - Employee satisfaction and contribution (interaction, involvement, environment)
 - Customer satisfaction knowledge (on tax laws procedural requirements and guidelines, and tax accounting principles)
 - Customer satisfaction application (application of tax laws, customer, relations, written communication)
 - An employee is rated as Exceeds/Meets/Fails for each performance aspect
 - Promotions and bonuses are tied to these ratings
- Educate your team and De-escalate your team with the IRS
 - Don't demonize these people.
 - Consider what is going on in their personal life.
 - Identify common values, lead with compassion, and listen to understand.
 - PASSED - Paraphrase, ask open ended questions, summarize, suspend judgement, empathize, and do not offer advice.



Upcoming R&D Best Practice Roundtable



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