



# TEI Minnesota Chapter ROUNDTABLE

November 29, 2023

WHITE PAPER

BECAUSE  
TODAY IS  
DIFFERENT



**MASSIE**

R&D Tax Credits

*Experience Best Practices*

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presented by  MASSIE

**Mark your calendars for  
our next Roundtable**

**March 28, 2024  
3 PM ET**

# Companies THAT ATTENDED

Ameriprise  
Basin Electric Power Cooperative  
Best Buy  
Cargill, Incorporated  
Ceridian  
CH Robinson  
Choice Hotels International  
CHS Inc.  
Compass Strategic Investments  
Deluxe Corporation  
Dominion Energy  
Entegris, Inc.  
General Mills  
Great Clips, Inc.  
Inspire Medical Systems  
Land O' Lakes, Inc  
Loram Maintenance of Way, Inc.  
Medtronic  
Mozarc Medical  
Pentair  
Polaris Inc.  
Prime Therapeutics  
Rahr Corporation  
Resideo Technologies  
Schwan's  
Securian Financial  
Spartan Nash  
Starkey Laboratories, Inc.  
Target Corporation  
Tennant Company  
Travelers Insurance Company  
U.S. Bank  
UnitedHealth Group  
UnitedHealthcare, Inc.  
US Bank  
Wells Fargo Bank NA

# Understanding the Implications of Notice 2023-63 on Section 174 Challenges

Jeffrey Moeller, Ivins Phillips

The issuance of Notice 2023-63 in early September has ignited a fresh round of discussions about the challenges posed by the Tax Cuts and Jobs Act (“TCJA”) provision, especially regarding the capitalization and amortization of Section 174 expenses. This whitepaper offers a comprehensive overview of the notice and its implications.

## Background on Section 174 Challenges

- The Regulations under Section 174 categorically define research or experimental (“R&E”) costs as those directly linked to developing or enhancing a product or a component thereof.
- However, the absence of detailed guidelines has made it evident that most indirect or allocable costs might be deductible under Section 162.

## Key Highlights from Notice 2023-63

- A pioneering allocation protocol for Section 174 expenses has been introduced.
- Section 4.03(1) sheds light on allocable costs, offering a non-exhaustive list.
- Conversely, Section 4.03(2) outlines costs that shouldn’t be treated as specified research or experimental (“SRE”) [AC1] expenditures, irrespective of their indirect ties to SRE activities.
- This introduced system demands less allocation than Section 263A but exceeds the stipulations of the INDOPCO Regulations.
- There’s active deliberation from the Treasury and IRS about introducing safe harbors, simplification methods, and optionality.

## A Look at Allocable Costs

- Labor
  - Encompasses both employees and contractors engaged in, overseeing, or directly aiding SRE activities
  - Note: Labor costs encompass all compensation facets, excluding severance.
- Materials and Supplies
- Cost-recovery
  - Incorporates depreciation, amortization, or depletion allowances for property used in SRE tasks, including those commissioned before December 31, 2021.
  - This raises pertinent questions: Is amortization legitimized to be capitalized? What sort of intangibles are deemed useful in SRE? Why should cost recovery be capitalized if the property was activated before the TCJA amendment's relevance?
- Patent costs
- Operation and Management
  - Consists of overhead costs tied to assets used SRE activities, including rent, utilities, insurance, repairs, taxes, and more.
- Travel

# Understanding the Implications of Notice 2023-63 on Section 174 Challenges

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## Costs That Are Non-allocable

- General & Administrative (“G&A”)
  - Departments that only indirectly aid SRE activities such as payroll, human resources, accounting, etc.
- Interest accrued on debts to fund SRE tasks
- Specific costs of internally developed computer software for business use
- Other expenditures previously excluded by §1.174-2
- Deductions from amortization under Section 174

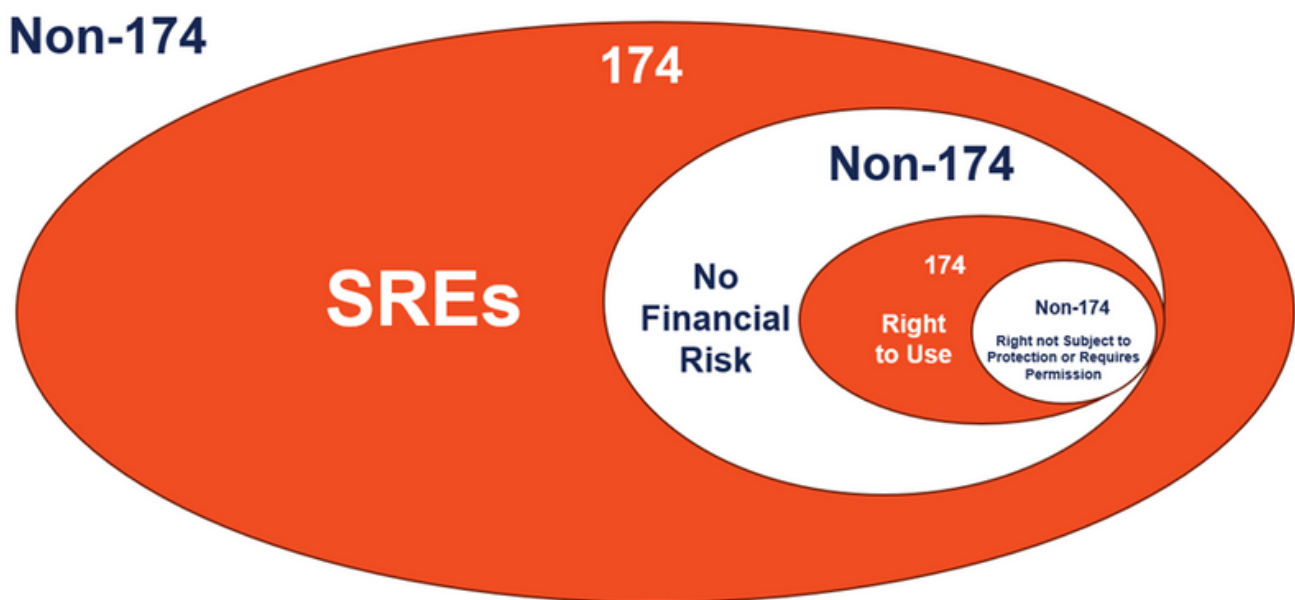
## Contract Research Insights from Notice 2023-53

- When a researcher shoulders financial risks:
  - Expenses are identified as SREs under Section 174.
  - Emphasizes fixed-price contracts where payments hinge on successful outcomes
- When a researcher is free from financial risks:
  - Expenses aren’t recognized as SREs under Section 174 unless the researcher “has a right to use any resulting SRE product in the trade or business of the [researcher] or otherwise exploit any resulting SRE product through sale, lease, or license.”
  - The term "SRE product" is defined expansively, covering pilot models, software, patents, and more.
  - However, a mere "right" is not inclusive of rights subject to permissions from unrelated entities.
- A potential for double capitalization arises for both the payor and researcher.
- Researchers need to be keenly aware of Section 174 when their performing activities intend to resolve uncertainties. The implications of this regulation are pivotal for how your expenses are handled.
  - If you're a researcher conducting tasks in line with Section 174 regulations, you fall under Section 174. This implies you have SREs and are obligated to capitalize and amortize them.
  - There's an intriguing notice to be aware of. If your research carries no financial risk, then you're no longer bound by Section 174 but will likely fall under Section 172.

# Understanding the Implications of Notice 2023-63 on Section 174 Challenges

Jeffrey Moeller, Ivins Phillips

Now, here's where it gets tricky. Even if you bear no financial risks but maintain a "right to use" the research output, you're once again in the realm of Section 174 and the obligations that come with it. However, this "right to use" isn't a blanket term; if it's not legally protected, you're exempted from Section 174.



Pictured Above: A breakdown of Section 174 and non-174 activities.

- "A Right to Use"
  - Treasury's Perspective: Simply using Intellectual Property (IP) for further development might suffice.
  - However, if your right involves receiving royalty payments from the research, it's likely not considered under this clause.
- Protection Under Law
  - The treasury essentially indicates that know-how doesn't count under this.
  - This raises a question: Could this be applicable to non-exclusive rights?
- The "Permission" Clause
  - A contract where a researcher retains rights to produce the item exclusively for the funding customer (like in follow-on contracts) falls under this

Notice 2023—63 – Request for Comments

Though the deadline for comments has passed, please continue to send them in. We have it on good authority that they will continue to read all comments submitted despite the deadline.

# Understanding the Implications of Notice 2023-63 on Section 174 Challenges

Jeffrey Moeller, Ivins Phillips

The Treasury has released Notice 2023—63 as a formal request for comments on several pivotal areas concerning Section 174 regulations and their broader implications.

This notice shines a spotlight on the intricacies of research expenditures, software development, contract research, and several other aspects.

Here's a breakdown of the primary focus areas for Jeffrey Moller

- Scope and Allocation of Section 174 Expenses:
  - Simplification via methods and safe harbors (e.g., ASC codes)
  - Special provisions for government contracts
- Software Development:
  - Possible redefinition (using, for example, ASC codes)
  - Identifying activities in software development that ought to be excluded
- Contract Research:
  - Questions arise on whether the criteria for determining if a research contract has SREs under Section 174 should be akin to the funded research rules under § 41(d)(4)(H)
  - Special rules for government-related contracts
  - Exploring other determining factors for Section 174 categorization
  - Setting safe harbors, particularly for research conducted outside the US
  - Defining rules for contracts with related foreign research contributors and beneficiaries
- Disposition, Retirement, or Abandonment of Property:
  - How to handle amortization in the context of contributions to or distributions from a partnership and within partnership transactions
- Long-Term Contracts (Section 460):
  - Considering a cost inclusion approach for the percentage of completion method
- Other Considerations:
  - Assessing if the current record-keeping mandates are adequate for validating Section 174 computations
  - Defining the term "pilot model"
  - Outlining special regulations for startups and smaller taxpayers
  - Interpreting references in §§ 280C(c)(1)(B) and 56(b)(2)(A) in relation to the amortization deduction under § 174(a)(2)

# Notice 2023-63 on Section 174 Challenges + Impact

Jason Massie, MASSIE R&D Tax Credits

- IRC Section 174 Renamed: Now termed "Specified Research or Experimental Expenditures" ("SRE")
- Obsolete Guidance: Rev. Proc. 2000-50 on software development costs is outdated
- New Methods: Introduction of Rev. Proc. 2023-08 and 2023-11
- Administrative Update: Notice 2023-63 was issued for additional guidance (Sept. 8, 2023)
- IRS Comment: Scott Vance indicated a moderate approach to changes in Sec. 41
- Upcoming Regulations: Expected in the upcoming Spring for further clarity

## Practical Application - Exclusions from Section 174

- Non-qualifying Activities Under §1.174-2(a)(6): Activities without technical uncertainty, such as:
  - Quality control testing
  - Efficiency and management studies
  - Consumer surveys
  - Advertising/promotional activities
  - Acquiring another's products
  - Research in literary or historical projects
- Excluded Costs:
  - Purchase of land or depreciable property for research
  - General and administrative functions only indirectly support SRE
  - Interest on debts incurred for research purposes

## Practical Application Example: Calculating 174 Capitalization for 2022

- Company's 2022 R&D Expenditures
  - W-2 R&D wages: \$15 million
  - Book stock compensation (related to R&D): \$1.5 million
  - Benefits, payroll taxes, overhead for development: \$2.5 million
  - Payment to foreign subsidiary for R&D (including 10% markup): \$3 million
  - Increase in GAAP capitalized software account: From \$55 million to \$70 million
- 174 Capitalization Calculation
  - Total U.S. costs: \$17.5 million (W-2 wages + benefits and overhead)
  - Total foreign costs: \$3 million (payment to a foreign subsidiary)
  - Book stock compensation is included in W-2 wages
  - Change in GAAP capitalized software balance treated as deductible
  - Cost-plus markup included in 174 capitalizations as per Notice 2023-63 Sec. 9
  - Total 174 Capitalization for 2022: \$20.5 million.



# Notice 2023-63 on Section 174 Challenges + Impact

Jason Massie, MASSIE R&D Tax Credits

## Practical Application - Software

- Definitions
  - Definition aligns with Rev. Proc. 2000-50: Emphasizes a similar understanding of what constitutes software
  - Components of Software
    - Computer programs or routines designed for specific functions
    - Necessary documentation for describing and maintaining the program
  - Inclusions in Software Definition
    - Upgrades and enhancements to existing software
    - Ancillary rights critical for acquiring title, ownership, or usage rights of the software
- Development Phases and Exclusions
  - Included in Software Development
    - Planning, including gathering requirements
    - Designing the software
    - Building a software model
    - Writing source code
    - Testing and modifying to fix defects
  - Limitation on Inclusion
    - Activities included only until the software is placed in service or technological feasibility for sale is established.
    - Exclusions from Software Development
      - Data conversion processes
      - Software installation and configuration
      - Training related to the software
      - Business reengineering activities
      - Maintenance (except upgrades or enhancements)
      - Development of data or information bases
      - Distribution-related activities
      - Customer support services

## Legislative Outlook

- H.R. 2673 - American Innovation and R&D Competitiveness Act of 2023: A significant bill focused on enhancing innovation and research and development in the U.S.
- S.866 - American Innovation and Jobs Act: Another pivotal act aimed at boosting American innovation and job creation in the R&D sector.
- Other Bills: Several additional bills have been introduced, indicating a legislative focus on innovation and R&D.

# Refund Claims & 6765 Changes for the Future

Catie Ely, Stephen Whiteaker & Jason Massie

MASSIE R&D Tax Credits

## R&D Timeline



## Court Cases Impacting Research and Credit Refund Claims

- **United States v. Quebe**, 321 F.R.D. 303 (S.D. Ohio, 2017): Taxpayers were sanctioned for not complying with court orders to detail their claim's business components, identify uncertainties, and describe the research performed by each employee.
- **CRA Holdings US, Inc. v. United States**, No. 1:15-cv-00239-EAW-LGF (W.D.N.Y 2019): The court required the taxpayer to specify employees involved in qualified research activities, including specific tasks, dates, time spent, and related expenses and emphasized the necessity of proving "qualified services" under I.R.C. § 41.
- **Harper v. United States**, Case No.: 18cv2110 DMS (LL) (S.D. Cal. 2019): Plaintiffs failed to provide a sufficient factual basis for their refund claims, lacking specific work identification and application of the statutory test to determine qualified research.

## Research Credit Refund Claim Directive Requirements

### Overview of Requirements for a Valid R&D Credit Refund Claim:

1. **Identify All Business Components:** Comprehensive listing required
2. **Detail Research Activities for Each Component:** Specific activities must be clearly identified
3. **List All Individuals Involved in Each Activity:** Names of participants in research activities
4. **Purpose of Research:** Information each individual sought to discover
5. **Summary of Qualified Research Expenses ("QRE"):** Includes wages, supplies, computer rental, and contract research costs

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## Characteristics of Approved Responses

What We Know	What We Don't Know
Claims reviewed by a group titled "classifiers"	Unclear what training classifiers receive
Classifiers are not accessible for feedback	The quality assurance level committed by the IRS is unknown
Inadequate claims result in Letter 6425C	No information on IRS metrics for claims deemed insufficient
The contact named in Letter 6425C is not the classifier and is inaccessible	

## Content of Submissions

Recommended Actions	Actions to Avoid
Create a detailed memorandum specifically to address the CCA 5 Items of Information	Attach a general study
Describe each business component clearly for classifier understanding	Use vague groupings or types for business components
Provide detailed information on the research purpose	Use conclusory language or restate Code requirements
Organize information for easy classifier access	Overwhelm (or "paper bomb") the classifier with excessive documentation

# Refund Claims & 6765 Changes for the Future

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## Guidance on Research Credit Claims – Key Resources and Updates

- FAQ on Section 41 Research Credit Claims on Amended Returns:
  - Provides answers to common questions
  - Includes a dedicated feedback email: [irs.feedback.recredit.claims@irs.gov](mailto:irs.feedback.recredit.claims@irs.gov)
- Memorandum LB&I-04-0122-0001:
  - Offers guidance to classifiers on the required information and form for claims
- IRM Procedural Update wi-21-0523-0643:
  - Details procedures for resubmissions under review
  - Helps in understanding the IRS's approach to handling amendments

## Responding to Letter 6426C: Key Considerations

IRS Department of the Treasury  
Internal Revenue Service  
OOEN UT 84261-9338 In reply refer to [redacted]  
July 29, 2022 LTR 6426C

Taxpayer Identification number: [redacted]  
Tax period: 04-31-2020  
Form: 1120

Dear Taxpayer:

We cannot process your claim for the Section 41 Credit for Increasing Research Activities for the tax period above because you didn't describe, in detail, each ground for which you're claiming the refund or credit, or provide sufficient facts supporting your claim, as required by Treasury Regulation Section 301.6402-2.

For us to consider your claim, you must provide a written statement that identifies:

- All the business components to which the Internal Revenue Code Section 41 research and experimentation credit relates for the claim years.
- All the research activities performed for each business component to which the Internal Revenue Code Section 41 research and experimentation credit relates for the claim years.
- All the individuals who performed each research activity for each business component to which the Internal Revenue Code Section 41 research and experimentation credit relates for the claim years.
- All the information each individual sought to discover for each business component to which the Internal Revenue Code Section 41 research and experimentation credit relates for the claim years.
- All the information each individual sought to discover for each business component to which the Internal Revenue Code Section 41 research and experimentation credit relates for the claim years.

For the fastest resolution please respond by fax to the fax number listed below and include [redacted] as the contact name.

Please send us the requested information within 45 days from the date of this letter. You can mail it to the address at the top of the first page of this letter or fax it to [redacted] using either a fax machine or an online fax service. Several online fax services use the Internet to send files from your computer or smart device to a fax number.

If we don't receive your information or receive insufficient information, we cannot consider your claim for refund or credit.

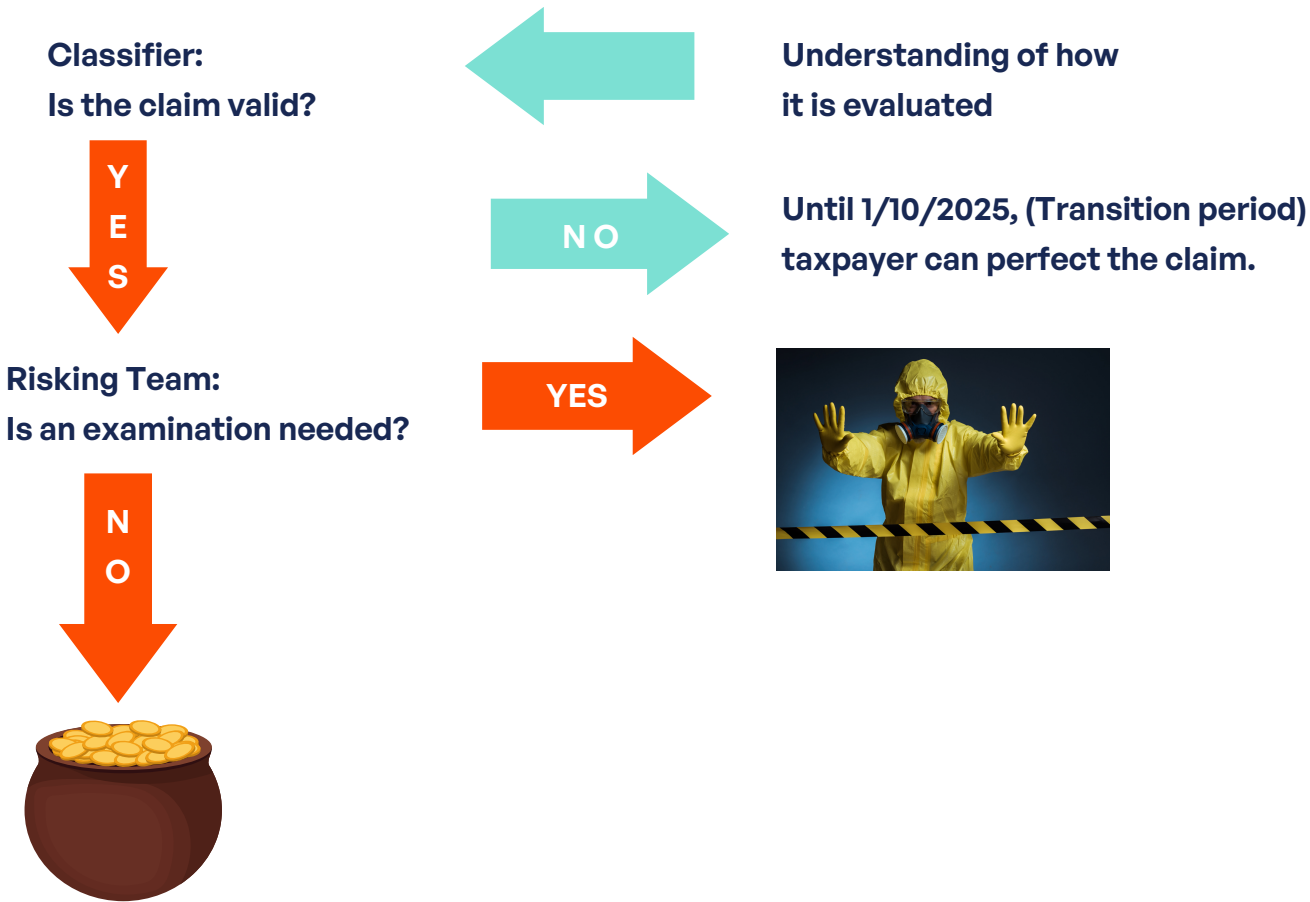
- All the business components to which the Internal Revenue Code Section 41 research and experimentation credit relates for the claim years.
- All the research activities performed for each business component to which the Internal Revenue Code Section 41 research and experimentation credit relates for the claim years.
- All the individuals who performed each research activity for each business component to which the Internal Revenue Code Section 41 research and experimentation credit relates for the claim years.
- All the information each individual sought to discover for each business component to which the Internal Revenue Code Section 41 research and experimentation credit relates for the claim years.

- Evaluate Original Submission: Carefully review what was initially filed
- Read Letter 6426C Thoroughly: Understand the specifics and implications of the IRS's letter
- Avoid Repetition: Do not resubmit the same information that was previously filed
- Make a Comprehensive Response: Ensure the response covers all necessary aspects and addresses the IRS's concerns
- Use a Tracking Method for Response: Respond in a way that allows for tracking and confirmation of receipt
- Document Your Process: Maintain thorough documentation in your files for reference and record-keeping

# Refund Claims & 6765 Changes for the Future

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MASSIE R&D Tax Credits

## Evaluation Structure



## IRS Risk Analysis Approach

- Comprehensive Risk Analysis:
  - The IRS conducts risk assessments on cases and issues.
  - LB&I (Large Business and International) Campaigns are part of this risk analysis.
- Centralized Risking under IRC 41 and 174:
  - Focus on research issues through a Research Risk Review Team (“RT”)
- Composition of the RT:
  - Includes SMEs, attorneys, engineers, revenue agents, and other specialists
  - Aimed at promoting compliance and identifying high-risk returns and claims
- Knowledge Sharing and Collaboration:
  - RT engages in knowledge sharing for better identification and evaluation of risks.
- Benefits of Comprehensive Analysis:
  - Ensures proper depth and scope of examination
  - Supports consistent and efficient examination of research issues as per IRM 4.46.3.2.6.8 (1-23-2023)

# Refund Claims & 6765 Changes for the Future

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## Challenges and Best Practices

- Problems Identified:
  - Backlog due to lack of resources.=
  - Inconsistent results stemming from inadequate training
  - Lack of transparency on claim status
- Claim Submission Process:
  - 45-day letter followed by a 60-day suspension period before a rejection letter
  - Recommended to fax and mail submissions with proof
- Statute of Limitations: Important consideration in claim processing
- Best Practice Example Submission for Five Items of Information for Research Credit Claims for Refund

1. Identify all business components to which the IRC Section 41 research credit claim for refund relates for the claim year.

Business Component Number	Business Component Name	IRC Section 41(D)(2)(B) Category
1	Alpha Software Suite	Computer Software
2	Beta Manufacturing Line	Process
3	Gamma Widget	Product
4	Delta Coating	Formula

2. Identify all research activities performed by business component.

1. Alpha Software Suite  
 Taxpayer sought to improve the performance and quality of its inventory and process tracking systems. The research performed included:
  - Integrate Radio Frequency Identification (RFID) part tracking with factory process tracking software and accounting software, all currently residing on different software platforms.
  - Develop real-time reporting from above software systems so end users can track product through the facility. This requires database development from currently disparate systems.
2. Beta Manufacturing Line  
 Newly designed line to improve throughput and quality of Beta widgets.  
 The research performed included:
  - Design new manufacturing equipment capable of higher throughput by designing and building higher speed injector process that is also capable of meeting tighter tolerances due to the mold wall design of withstanding temperatures without expanding.
  - Integrate all of the new manufacturing equipment into a new production line with redesigned conveyors and automated material handling capable of increasing throughput. The challenges came in reducing jams in the line and damage of widgets.
  - Develop a software handshake between new components; the new components were not originally designed to share data with one another. A piece of equipment known as a "communication doodad" was added to the system, and a section of code was developed allowing the doodad to translate and pass data from one system to the next.

3. Identify all individuals who performed each research activity by business component, and

4. Describe all the activities and information each individual sought to discover by business component.

Business Component Number	Job Title	Qualified Service Category	Activities and Information Each Individual Sought to Discover by Business Component
1	Software Developer	Qualified Research	Developed functional requirements, coding of software, and testing in facility. Integrate data from disparate systems by researching alternatives.
1	Engineering Manager	Direct Supervision	Direct supervisor of Software Developer and Project Engineer.
1	Project Engineer	Qualified Research	Hardware and peripheral development in the facility to work hand-in-hand with software tracking. Experimented with multiple RFID readers and chips. Experimented with RFID chip location on parts and readers in the plant to maximize successful reading of chip.
2	Project Engineer	Qualified Research	Designed manufacturing equipment including and tested capabilities with several different higher speed injectors.
2	Software Developer	Qualified Research	Programmed logic controllers for the conveyor and automated material handling systems.
3	Project Engineer	Qualified Research	Designed internal structure and led testing of the iterative designs.
3	Metallurgist	Qualified Research	Worked on development of material(s) to withstand extreme conditions.
4	Lab Technician	Direct Support	Compiled test data for Chemical Engineer.
4	Chemical Engineer	Qualified Research	Developed formulations to test in extreme environments.
4	Lab Manager	Direct Supervision	Direct supervisor of Lab Technician and Lab Manager.

## Overview of the Example

- Fictional Taxpayer Scenario:
  - The example shows how a hypothetical taxpayer might complete the form.
  - Notable for its brevity and succinctness
- IRS Approval: This concise example has received IRS endorsement, though it's unclear if the level of detail is sufficient for classifiers to fully grasp the project scope.

# Refund Claims & 6765 Changes for the Future

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MASSIE R&D Tax Credits

## Specifics of the Form

- Question 2 - Business Components:
  - The form requires a detailed listing of business components.
  - Emphasizes specificity over broad project families or groupings.
  - Each name should pass the four-part test to determine its relevance.
- Questions 3 and 4 - Identifying Individuals and Activities:
  - Asks for identification of individuals involved in each research activity per business component.
  - Does not mandate listing individual names; job titles can be used.
  - If multiple job titles are involved in one component, grouping under one line item might be acceptable, but this is not yet confirmed.
  - Requires a description of the objectives pursued by each person or job title.

## Key Takeaways

- The IRS is looking for specific, detailed answers.
- The example serves as a guide for how to approach the form with the necessary level of detail.
- Users of the form need to carefully consider how they categorize and describe their business components and the individuals involved.

## Proposed 2024 New Form 6765

Form 6765, the existing R&D Tax Credit form, is undergoing proposed changes to address the need for more rigorous risk assessment and optimize IRS resource allocation. Initially requiring only 6/7 key numbers for a valid claim, the IRS is now seeking greater specificity in light of numerous inadequately substantiated claims. This shift towards more detailed reporting aligns with recent court cases emphasizing the importance of comprehensive disclosure. While originally anticipated as a 2024 issue, the full scope of these changes remains uncertain. Nonetheless, it's clear that preparers need to be ready for a more thorough information submission process to meet these evolving requirements.

# Refund Claims & 6765 Changes for the Future

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## Key Changes and Observations

- Page 1:
  - Minor changes, with particular emphasis on Section 280C queries, which have been repositioned to the beginning of the form
  - The form now inquires if one is part of a "controlled group or business under common control."
- Page 2:
  - New Section E: This introduces a business-component-centric approach.
    - Question 45: Addresses the correlation between the number of business components and risk assessment. The term "business component" is notably broad and crucial to the form
    - Questions 46-49: Previously considered supplementary, these questions are now integral to the form
    - Question 47: Introduces complexity regarding base period calculations
    - Question 48: The inclusion of the term "new category" necessitates further clarity
    - Question 49: Centers on the directive's status, emphasizing the significance of QREs claimed under the directive. It introduces a potential benefit by allowing the listing of "ASC 730" as a single line item. Conversely, listing all business components ("BCs") can be intricate and challenging to align
- Page 3:
  - Section F: Introduces several queries:
    - Will all U.S. entities need to complete this section?
    - Is there an exemption based on a QRE threshold?
    - How will large-scale taxpayers with numerous BCs ensure compliance?
    - Question 50(c): Focuses on the descriptive names of business components, suggesting the necessity for adaptability
    - Question 50(d): Represents a substantial paradigm shift, highlighting the challenge of detailing uncertainties and experimentation processes within a constrained space





# The Business Component Solution

Peter Green and Taylor Eiselin

MASSIE R&D Tax Credits

## The MASSIE Experience

- Focus: To make the R&D tax credit process more “user friendly”
- Goal: To claim and sustain the maximum credit possible with the least amount of work for our clients
- How: Incorporate today’s proven best practice solutions to deliver an R&D tax credit experience that is easier on the subject matter expert (“SME”) and the Tax Department

## Recap of IRS Proposed Changes to Form 6765

These proposed changes to Form 6765 require more detailed reporting on business components and expenses, reflecting a deeper dive into the specifics of R&D tax credit claims.

## Section E: Introduction of Five New Questions

1. Number of Business Components (“BCs”) in the Credit: Quantifying the total BCs involved.
2. Inclusion of Officers’ Wages: Clarifying if officers' wages are factored into the credit calculation
3. Business Acquisitions or Dispositions Reporting: Detailing any recent business acquisitions or dispositions
4. New Categories of Qualified Research Expenses (“QREs”): Identifying additional categories of QREs
5. Reliance on the ASC 730 Directive: Whether the ASC 730 accounting standard was used

## Section F: Detailed Information on Each Business Component - 14 New Data Points

- Entity Identification: EIN and business activity code
- Business Component Specifics:
  - Name and description of the Business Component.
  - Nature of the information sought, and alternatives evaluated in the experimentation process.
  - Classification as new or improved.
  - Type categorization (product, process, software, etc.).
  - Designation of end-use (sale, lease, license, business use).
  - Software-specific details (internal use, dual function, non-internal use).

# The Business Component Solution

Peter Green and Taylor Eiselin

MASSIE R&D Tax Credits

## Cost Details Per Business Component:

- Wages and Support Costs: Direct research, supervision, and support wages
- Supply and Equipment Expenses: Cost of supplies, rented/leased computers
- Contract-Related Expenses: Amount spent on contract expenses

MASSIE has created the Business Component Solution to combat the challenges associated with the proposed changes to Form 6765.

A recurring challenge many companies face is the low participation from SMEs. Often, tax directors feel burdened with administrative tasks such as constantly scheduling and rescheduling meetings. With this in mind, MASSIE has created a portal (using Microsoft Teams) to provide a seamless experience and address some new Form 6765 challenges.

## Architecture – Developing a Business Component Strategy

### Key Steps in Strategy Development

- Identify Innovation and SMEs: Pinpoint where innovation occurs and locate the experts involved.
- Utilize Existing Systems for Data Collection: Find systems already in place that can gather data usually requested from SMEs.
- Optimize Communication Methods: Determine the most effective communication channels like email, MS Teams (including tasks, chats, video calls), and specific Teams Channels.

### User Experience (“UX”) Testing

- Efficiency Through Detailed Testing:
  - Spending time testing with a few (like five people) can save time for many (like a hundred).
  - Deep dive into each question to ensure clarity and relevance.
  - Consider using internal jargon and industry-specific terms.
- Creating Helpful Resources:
  - Develop FAQs tailored to each industry or company.
  - Identify existing documents or artifacts that can simplify or eliminate questions.
  - Craft sample answers to guide users.

# The Business Component Solution

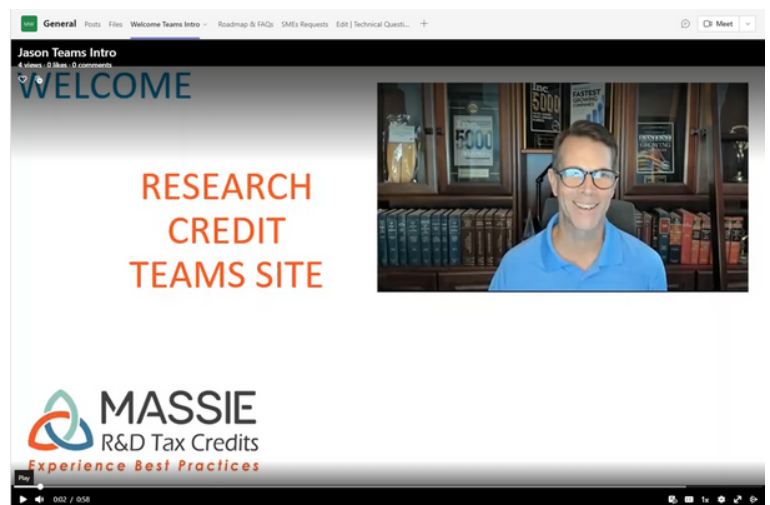
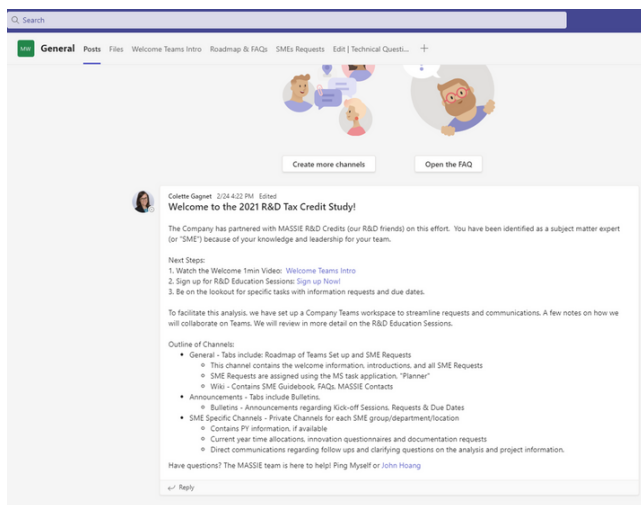
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MASSIE R&D Tax Credits

## Tool Development for Ease of Use

- Creating User-Friendly Tools:
  - Develop resources like self-guided videos, MS Forms, MS Bookings, printable guidebooks, model answers, and documentation mapping.
  - Offer various meeting options to accommodate different needs and preferences.
- Finalizing Project Plan and Timeline: Agree on a comprehensive project plan and establish a clear timeline.

## The Teams R&D Collaboration Hub

The Teams R&D Collaboration Hub is designed with the SME user experience in mind. It serves as an efficient, one-stop platform for data collection essential for R&D studies. The primary aim is to make the user's interaction with the tool as straightforward and hassle-free as possible.



## Key Features

- Group Video Kick-Off Meetings:
  - Options for both small and large groups
  - Multiple viewing opportunities for MS Teams training
- Planner Tasks:
  - Easy-to-follow instructions for SMEs
  - A checklist of tasks with automated reminder emails from MS Teams as deadlines approach or pass

# The Business Component Solution

Peter Green and Taylor Eiselin

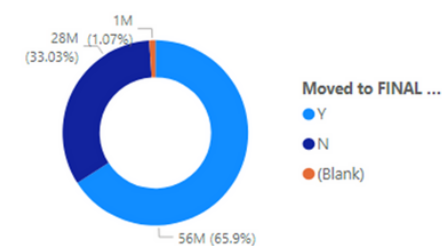
## MASSIE R&D Tax Credits

- Innovation Workbook:
  - Tools for calculating QRE percentages and BC allocation
- TEAMS Forms and Model Answers:
  - Structured forms and standard answers for the four-part test
- Documentation Mapping:
  - SMEs can easily track and locate R&D-related documentation
- FAQs and Real-Time Support:
  - Centralized FAQs for quick reference
  - A help desk for detailed response analysis
  - Real-time chat feature for instant messaging with SMEs
  - Option to arrange immediate 1:1 support calls

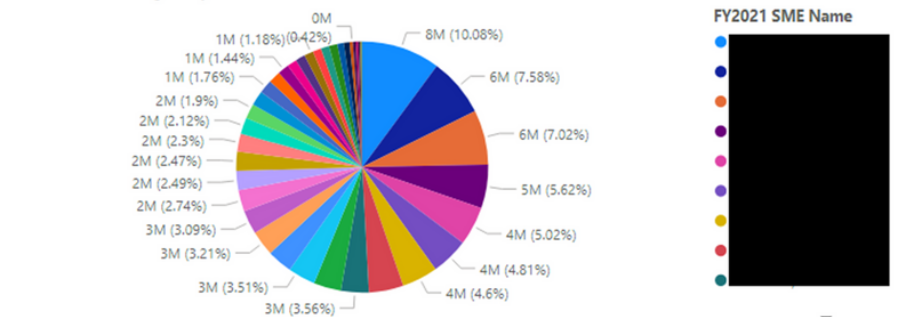
### Visibility & Control

The tax department maintains full oversight and control throughout the process, ensuring a transparent and managed workflow.

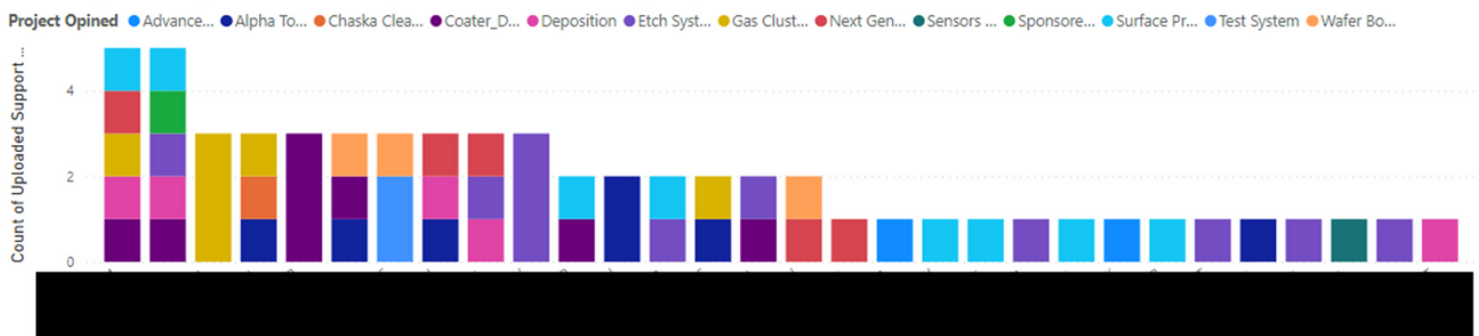
FY2021 R&D Wages by Moved to FINAL Folder per FA (Y)



FY2021 R&D Wages by FY2021 SME Name



Count of Uploaded Support Doc(# of Docs) by FY2021 SME Name and Project Opined





# Research Credit Cases & Controversy

Doug Norton and Michelle Andrighetto

Morgan Lewis LLP

## Emerging Challenges

- Recent Case Trends: The outcomes and reasoning in recent cases have largely been unfavorable to taxpayers.
- Increased Focus on Substantiation: There's a recurring emphasis on the taxpayer's responsibility to provide sufficient proof, particularly at the business component level.
- Limited Positive Outcomes: While there are some favorable decisions, they are few and require diligent search to identify.

A Trilogy of Cases: first, *Trinity Indus., Inc. v. U.S.* (N.D. Tex. 2010), then *Little Sandy Coal Co. v. Commissioner* (U.S. Tax Ct. 2021), and now *Little Sandy Coal Co. v. Commissioner* (7th Cir. 2023).

## Trinity Industries, Inc. v. U.S. (2010)

- Concerned Mark V deployment craft and Dirty Oil Barge, innovative nautical vessels developed under contract.
- The court acknowledged the risk involved in such novel projects: "If a first-in-class ship is sufficiently experimental, the risk of failure attaches to the entire project."
- Trinity Industries saw a favorable outcome, with the court recognizing the broader scope of research expenditures: "The Court finds that the additional expenses the government cites are properly considered research expenditures..."

## Little Sandy Coal Co. v. Commissioner (Tax Ct. 2021)

- Focused on costs related to Tanker and Dry Dock projects.
- Key was the 'substantially all' rule: "80 percent or more of a taxpayer's research activities... constitute elements of a process of experimentation for [a qualified purpose]."
- The court clarified the scope of includible activities: "Those who directly support research are, by definition, not engaged in research. Consequently, their activities cannot be viewed as elements of any process of experimentation."

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Little Sandy (7th Cir. 2023)

- Refining the Four-Part Test:
  - The case brought a nuanced view of Section 174 and the Process of Experimentation Test, focusing on the "analytical technique by which a hypothesis is formulated and then systematically tested..."



- Agreements and Disagreements with the Tax Court
  - Agreed with rejecting the "novelty approach" and applying the test at the business component level
  - Disagreed on the exclusion of pilot model production costs from the numerator, noting: "If the pilot model was used to evaluate alternatives as part of a 'methodical plan involving a series of trials to test a hypothesis,' the model production activities would also constitute elements of a process of experimentation"
- Taxpayer's Burden of Proof
  - The court emphasized the need for documentation: "Taxpayer has the burden to document that the activities accounted for by the nonproduction wages were elements of a process of experimentation"
  - It highlighted the limitations of generalized descriptions and arbitrary estimates in proving experimentation activities

The rulings across these cases highlight the criticality of detailed and specific substantiation for R&D tax credit claims.

Including pilot model expenses in the 'substantially all' test underlines the necessity of nuanced evaluation of R&D expenditures.



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Moore v. Commissioner, T.C. Memo. 2023-20

Context: Ms. Moore, as the sole owner and CEO of Nevco, an S corporation, faced scrutiny over claimed research credits on joint tax returns. Nevco specializes in manufacturing scoreboards and LED displays for sporting events.

- Key Issues
  - Nevco's claim that 65% of compensation for the President/COO was attributable to QREs
  - Lack of detailed records differentiating the President/COO's time spent on qualified research from general product development activities
- Tax Court Findings
  - Acknowledgment of Nevco's involvement in product development projects
  - Estimation that the President/COO devoted 50-65% of his time to product development, including activities potentially qualifying as research
  - Rejection of the QRE claims due to insufficient evidence separating qualified research from broader product development efforts
- Critical Observations
  - The Tax Court's potential misapplication of the four-part test on individual activities rather than on the business components being developed
  - There is emphasis on the claimant's responsibility to substantiate QREs, with courts showing reluctance to accept estimates without strong evidentiary support.

U.S. v. Grigsby,  
635 F. Supp. 3d 467 (M.D. La. 2022)

- Case Overview
  - Taxpayers, shareholders of Cajun (an S corporation), faced legal challenges over additional research credits claimed for Cajun's wide range of construction services.
  - A research credit study by AlliantGroup suggested Cajun was entitled to over \$1.3 million in additional credits. This led to an amended tax return, resulting in a dispute with the IRS.

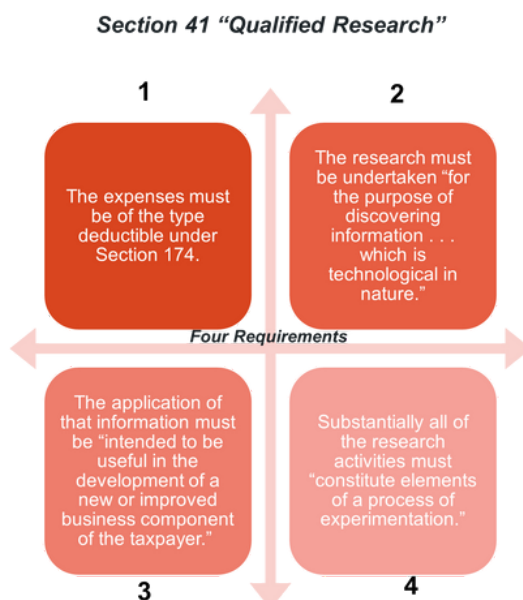
# Research Credit Cases & Controversy

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- Key Legal Findings

- The District Court granted summary judgment in favor of the government, denying the research credits and refund.
- It found that Cajun did not perform qualified research, and even if it did, the research was considered funded, making it ineligible for credit.
- The taxpayers failed to provide competent evidence of “qualified research,” specifically lacking clarity on how it related to the development of new or improved business components.



- Critical Observations

- The case highlights the necessity for taxpayers to clearly define and substantiate new or improved business components related to research activities.
- It emphasizes the importance of contractual terms in determining credit eligibility, focusing on the allocation of rights and financial risks.
- Appeal and Further Analysis (Fifth Circuit):
- The Fifth Circuit affirmed the District Court’s decision, agreeing that Cajun’s activities did not constitute eligible business components and were funded research.
- The court clarified that not all fixed-price contracts are unfunded and stressed the importance of who bears the risk of unsuccessful research.
- The East Bank Project analysis further supported the funded nature of Cajun’s activities, as Cajun was fully compensated for all expenditures, making the research funded.





# Research Credit Cases & Controversy

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## Harper v. Commissioner, T.C. Memo. 2023-57

- Case Overview
  - HCC, a construction firm specializing in military design-build projects, claimed research credits.
  - Its projects included diverse constructions like aircraft hangars, medical clinics, and solar-powered water tanks, encompassing various phases from conceptual design to construction.
- Representative Activities: The firm's activities included estimations, cost studies, scheduling, constructability reviews, design management, and more, aiming to demonstrate innovative construction approaches.
- IRS's Rejection and Tax Court's Response
  - The IRS challenged the claim on the grounds that HCC did not own the buildings, the designs were not "products" for sale, and HCC did not "use" the designs in a meaningful legal sense.
  - The Tax Court rejected the IRS's broadside challenges:
    - It did not dismiss the possibility that HCC's designs were new or improved.
    - The Court considered that designs could constitute processes, techniques, or inventions, even if they were not traditional "products."
    - The Court noted that the relevance of HCC's designs or buildings being "for sale" is not strictly necessary for research credit eligibility.
    - It clarified that the statutory term "use" does not need to align with IRS's narrow interpretation.

## Betz v. Commissioner, T.C. Memo 2023-84

- Case Overview
  - Taxpayers, shareholders in CPI (designing and supplying air pollution control systems), claimed R&D tax credits based on a study by Alliantgroup ("AG").
  - The IRS disallowed the credits and imposed accuracy-related penalties, a decision upheld by the Tax Court.
- Key Findings
  - The Court concluded that taxpayers failed to substantiate both the supply and wage QREs.
  - It focused on whether these expenditures met the "qualified research or experimental expenditures" criteria under section 174.



# Research Credit Cases & Controversy

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- Taxpayer's Position
  - Supply QREs: Included payments for components, fabrication, and assembly services. AG's analysis calculated a fixed base percentage and gross receipts to compute the credit.
  - Wage QREs: Lacked a formal time-tracking system, relying on estimates and interviews to allocate wages to projects.
- Tax Court's Analysis
  - Supply QREs and Pilot Model Exception:
    - Determined that expenditures included services, not just physical components.
    - The "pilot model" exception required evidence of resolving uncertainty, which the taxpayers did not provide.
  - Wage QREs: Evaluated each of the 19 projects individually and found insufficient evidence for investigative activities or a process of experimentation.
- Key Takeaways
  - Wage QREs: Taxpayers must demonstrate that specific employees performed qualified services related to a business component.
  - Pilot Model Exception: Taxpayers must illustrate the use of a pilot model in resolving product uncertainty.
  - Section 174 Expenditure Criteria: Taxpayers need to show that there was a lack of available information and that investigative activities were undertaken to discover such information.
  - Penalties: The Tax Court upheld accuracy-related penalties, noting a lack of good faith or reasonable cause defense from the taxpayer.

J.G. Boswell Co. v. Commissioner (Order, Tax Ct. July 2022)

- Case Overview
  - The case involved J.G. Boswell Co., a large farming business, claiming QREs for supply and labor costs incurred in agricultural research trials on various crops.
  - The research trials were conducted on 7% of the company's land, designated as "research acres," with the remaining 93% being "production acres."

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- Tax Court Decision
  - The Tax Court denied both Boswell's and the IRS's motions for summary judgment.
  - The Court followed the precedent set in Union Carbide in rejecting Boswell's claim that production-type costs could be considered QREs when research focuses on a production process.
  - However, the Court also rejected the IRS's broader interpretation that any expenditures that would normally occur in standard production processes are automatically disqualified as QREs, even if the research aims to improve the product rather than just the process.



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**Mark your calendars for  
our next Roundtable**

**March 28, 2024  
3 PM ET**

