

ABOUT KBKG



Established in 1999 with offices across the US, KBKG provides turn-key tax solutions to CPAs and businesses. By focusing exclusively on value-added tax services that complement your traditional tax and accounting team, we always deliver quantifiable benefits to clients.

Our firm provides access to our knowledge base and experienced industry leaders. We help determine which tax programs benefit clients and stay committed to handling each relationship with care and diligence. Our ability to work seamlessly with your team is the reason so many tax professionals and businesses across the nation trust KBKG.

SERVICES OVERVIEW



Research & Development Tax Credits

Federal credit worth approximately 10% of every qualified dollar spent on developing brand new or improving existing products, processes, software, and formulae.



Cost Segregation for Buildings and Improvements

Any building improvement over \$750,000 should be reviewed for proper classification of the individual components for tax depreciation, and retirement purposes.



45L Credits for Energy Efficient Residential Developments

Newly constructed or renovated apartments, condos, and tract home developments that meet certain criteria are eligible for a \$2,000 credit per unit.



179D Incentive for Energy Efficient Commercial Buildings

Federal deduction worth \$1.80 per square foot of energy-efficient buildings. Available to architects, engineers, design/build contractors and building owners.



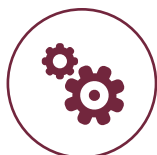
IC-DISC

The Interest Charge Domestic International Sales Corporation (ICDISC) offers significant Federal income tax savings for making or distributing U.S. products for export. IC-DISC benefits are available to qualified producers or distributors that are either directly involved in exporting, or selling products to distributors or wholesalers who resell for use outside of the U.S.



Transfer Pricing Services

The cross-border transfer prices of goods, royalties, services, and loans drive how much income tax a multinational company pays by country. We assist US and international companies in establishing, documenting, and defending transfer pricing practices for the IRS and international tax authorities.



Fixed Asset Review

While a cost segregation study focuses on buildings, a comprehensive Fixed Asset Tax Review encompasses all fixed assets a company owns including real property, machinery, furniture, fixtures, and equipment.



Repair vs. Capitalization Review §263(a)

Taxpayers often capitalize major building expenditures that should be expensed as repairs and maintenance such as HVAC units, roofs, plumbing, lighting and more. Retirement loss deductions for demolished building structural components are also identified.

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INDUSTRY MATRIX FOR TAX SAVING OPPORTUNITIES



At KBKG, we are committed to identifying all possible tax saving opportunities for our clients and CPA partners. Our detailed Industry Matrix helps quickly determine which tax credits and deductions apply by industry at a glance. Our chart alone provides some insight to ensure that businesses are seeking out all potential benefits; however, KBKG's certified engineers and technical experts perform a thorough assessment during the engagement process to be sure all possible incentives are identified and considered.

INDUSTRY	R&D TAX CREDITS	REPAIR/ ASSET RETIREMENT	45L TAX CREDITS	179D TAX DEDUCTIONS	COST SEGREGATION / FIXED ASSET	IC-DISC	*TRANSFER PRICING	EMPLOYEE RETENTION TAX CREDIT
Affordable Housing		✓	✓	✓	✓			✓
Agriculture, Forestry & Fishing	✓				✓	✓	✓	✓
Architecture & Engineering	✓			✓	✓	✓		✓
Auto Dealerships		✓		✓	✓			✓
Cannabis	✓				✓			✓
Communications & Utilities	✓	✓			✓	✓		✓
Construction	✓				✓			✓
Film & Music	✓				✓	✓	✓	✓
Financial Services	✓	✓			✓		✓	✓
Government Contractors	✓			✓	✓	✓		✓
Healthcare	✓	✓		✓	✓		✓	✓
Home Builder			✓					✓
Hotels	✓	✓		✓	✓		✓	✓
Manufacturing & Distribution	✓	✓		✓	✓	✓	✓	✓
Mining	✓				✓	✓	✓	✓
Multifamily Developers		✓	✓	✓	✓			✓
Oil & Gas	✓	✓			✓		✓	✓
Pharmaceutical	✓	✓		✓	✓	✓	✓	✓
Professional Services	✓	✓			✓		✓	✓
Real Estate		✓		✓	✓			✓
Restaurants		✓			✓			✓
Retail	✓	✓		✓	✓			✓
Technology/Software	✓				✓	✓	✓	✓
Transportation	✓				✓		✓	✓
Wholesale Trade	✓	✓		✓	✓	✓	✓	✓

*May apply to any industry as long as the company has cross border subsidiaries. Industries indicated are more likely to have multinational business.

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IDENTIFYING VALUE-ADDED TAX OPPORTUNITIES



KBKG SERVICE	DESCRIPTION & HIGHLIGHTS	APPLICABLE CLIENTS & INDUSTRIES	HOW MUCH IS IT WORTH?	TAX CONSIDERATIONS
RESEARCH & DEVELOPMENT TAX CREDITS (FEDERAL & STATE)	<p>Federal and State tax credit – designed to promote innovation. Expenses incurred in the United States and that meet the qualification criteria can result in a credit.</p> <p>Qualifying expenses can include wages paid to employees, supplies used in the research process, and payments made to contractors for performing qualified research.</p>	<p>Clients developing brand new products, processes, software, or formula.</p> <p>Clients materially improving existing products, processes, software or formula.</p> <p>Clients that employ those with technical backgrounds including:</p> <ul style="list-style-type: none"> • Manufacturing • Software Development • Architecture • High Tech • Food & Beverage • Equipment or tools • Life Sciences • Agriculture 	<p>Federal Benefit - Roughly 10% of their total Qualified R&D Expenses</p> <p>Ex.: Client has \$1M/year of wages related to R&D. Benefit = \$100k in gross credits per year.</p> <p>Many states also allow an R&D credit. For example, CA R&D Credit is worth an additional 7.5% of Qualified R&D expenses.</p>	<ul style="list-style-type: none"> • Dollar-for-dollar reduction in income tax liabilities. • 1-year carryback / 20-year carryforward of unused credits. • Qualified small businesses can reduce alternative minimum tax liabilities. • Qualified start-up companies can offset up to \$250,000 in payroll taxes.
COST SEGREGATION (FEDERAL & STATE)	<p>Allows taxpayers who have constructed, purchased, expanded, or remodeled any kind of real estate to accelerate depreciation deductions by reclassifying building components into shorter tax lives.</p>	<p>Any building with over \$750k of depreciable tax basis (excluding land).</p> <p>Any leasehold improvement with over \$500k of depreciable tax basis (excluding land).</p> <p>Any smaller residential rental property with over \$150k of depreciable tax basis (excluding land) can utilize KBKG's online software to generate a cost segregation report.</p>	<p>Net Present Value is roughly 5% of the total building cost.</p> <p>Ex.: \$2M office can yield an after-tax NPV of \$100k.</p>	<ul style="list-style-type: none"> • Reduces AMT • Starting in 2018, unused deductions carryforward. • Must recapture personal property and bonus eligible assets upon the sale of a building.
TRANSFER PRICING (INTERNATIONAL)	<p>Federal credit for developers of apartments, condos, or spec homes that meet The transfer prices of goods, royalties, services, and loans drive how much income tax is paid by country. Corrections to transfer pricing may lead to significant improvements in a company's global effective tax rate.</p> <p>Savings dependent on differences in tax rates between countries and can be significant.</p> <p>Tax reform provides incentives for companies to generate income in the US with lower rates certain energy efficiency standards.</p> <p>Units must be certified by a qualified professional to be eligible.</p>	<p>All US and foreign-owned multinational companies.</p> <p>Transfer pricing rules apply to goods, services, royalties, loans and other cross-border transactions in all industries</p> <p>Companies with supply chain restructuring programs, new R&D facilities, or international subsidiaries are often best placed to realize benefits.</p>	<p>US tax reform has created opportunities to improve global effective tax rates through changes to transfer prices, e.g.</p> <ul style="list-style-type: none"> • Foreign Derived Intangible Income ("FDII") allows C-Corporations to pay a 13.125% rate on some export income • Changes to transfer prices of imported goods may also lead to tax savings at the 21% rate. • Substantial benefits when correcting transfer pricing to utilize tax net operating losses. 	<p>Companies without transfer pricing documentation can face additional tax, interest, non-deductible penalties and double tax for all open tax years.</p> <p>Tax authorities are concerned about multinational companies paying their "fair share" of income tax in each country where they operate.</p>

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IDENTIFYING VALUE-ADDED TAX OPPORTUNITIES



KBKG SERVICE	DESCRIPTION & HIGHLIGHTS	APPLICABLE CLIENTS & INDUSTRIES	HOW MUCH IS IT WORTH?	TAX CONSIDERATIONS
RESIDENTIAL ENERGY CREDITS / SECTION 45L (FEDERAL / STATES CAN HAVE SIMILAR PROGRAMS)	Federal credit for developers of apartments, condos, or spec homes that meet certain energy efficiency standards. Units must be certified by a qualified professional to be eligible.	Anyone that has built apartments, condos or production home developments (3 stories or less), in the last 4 years. Generally, more than 20 units.	Federal credit = \$2,000 per apartment/home unit. Many states have similar credits. Ex.: 100-unit apartment/condo can get \$200,000 of Federal Tax Credits.	<ul style="list-style-type: none"> • Credit is realized when unit is first leased or sold, not placed in service. • 1-year carryback • 20-year carryforward. • Does not reduce AMT. • Subject to passive activity loss rules • Credit reduces basis.
COMMERCIAL ENERGY DEDUCTIONS / SECTION 179D (FEDERAL/ STATES CAN HAVE SIMILAR PROGRAMS)	Federal deduction for architects, engineers, and design/build contractors that work on public or government buildings such as schools, libraries, courthouses, military housing etc. Also available to any commercial building owner.	<ul style="list-style-type: none"> • 179D for designers: Architects, general contractors, engineers, electrical & HVAC subcontractors. • Any building owner or lessee: That has constructed a commercial improvement greater than 50,000 SF since 1/1/2006. 	\$.30 up to \$1.80 per square foot in federal tax deductions. Ex.: 100,000SF building is eligible for \$180,000 in deductions.	<ul style="list-style-type: none"> • Reduces AMT • Deduction reduces basis in real property. • Designers must amend open tax years to claim. • Owners can go back to 2006 with Form 3115 to claim missed deductions.
FIXED ASSET TAX REVIEW (FEDERAL)	Comprehensive review of a company's entire fixed asset listing and supporting documents to assign appropriate tax lives, identify retirements, and correct items that should be expensed. Includes cost segregation and repair analysis.	Operations with > \$40M in real property or > 500 lines of fixed assets. <ul style="list-style-type: none"> • Retail, restaurant, bank and hotel chains of 10 or more • Manufacturing • Utility companies 	Net present value (NPV) of 5-8% of total building-related costs. Ex.: Manufacturing client has \$60M of 39-year fixed assets. NPV Cash value = \$3M - \$4.8M	<ul style="list-style-type: none"> • Reduces AMT • Starting in 2018, unused deductions carryforward. • Must recapture personal property and bonus eligible assets upon the sale of a building.
REPAIR V. CAPITALIZATION REVIEW "ASSET RETIREMENT STUDY" (FEDERAL)	New rules allow you to assign value to "structural" components removed from a building and write off the remaining basis. Regs also clarify repair expense treatment of many types of building costs such as HVAC or roof replacements. KBKG also provides compliance consulting for repair and disposition regulations.	Any building renovation costs > \$400k Retirement Study - Building is renovated AFTER owning it at least 1 year. Building should have <u>> \$500K of remaining depreciable basis left.</u> Repair Study - renovations that include roof, HVAC, windows, lighting, plumbing, ceilings, drywall, flooring, etc.	Additional Year 1 deductions of 15%-40% of renovation costs (on top of benefits from 1245 reclassification) Ex.: Client spends \$3M on structural renovations. Additional Year 1 deductions of \$450K-\$1.2M.	<ul style="list-style-type: none"> • Depending on project specifics, may require a separate 3115 if doing concurrently with a depreciation change.
IC-DISC FEDERAL INCOME TAX INCENTIVE (FEDERAL)	The IC-DISC provides significant and permanent tax savings for producers and distributors of U.S.-made products and certain services used abroad.	Any closely held, privately owned business with over \$250,000 in profits from exports <ul style="list-style-type: none"> • Manufacturers • Distributors • Architects & Engineers • Agriculture and Food Producers • Software Developers • Other Producers 	Minimum permanent 17% decrease in tax rate on half of export profits. Benefits can be dramatically higher by performing a transaction-by-transaction analysis.	<ul style="list-style-type: none"> • Requires annual filing 1120 IC-DISC. • No changes to business operations. • Benefits begin when entity is formed.

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Qualified Improvements - Depreciation Quick Reference (updated 3/30/2020)

	Applicable PIS Dates (inclusive)	MACRS GDS Recovery Period	Bonus Dep Eligible	3 Year Rule	Unrelated Parties Rule	179 Expense Eligible	Important Notes	Code Section
Qualified Improvement Property (QIP): 2018 - Onward	01/01/18 - onward	15 Year / SL	Y	N	N	Y ⁹	Applies to interior common areas. Building can be owner occupied. No 3-year rule. See exclusions in definition.	168(e)(6)
Qualified Improvement Property (QIP): 2016 - 2017	1/1/16 - 12/31/17	39 ⁵ Year / SL	Y	N	N	N ⁷	Applies to interior common areas. Building can be owner occupied. No 3-year rule. See exclusions in definition.	168(k)(3)
Qualified Leasehold Improvements (QLI): 2004 - 2017	10/23/04 - 12/31/17	15 Year / SL	Y ¹	Y	Y	2010 - 2017 ⁶	Landlord or lessee can make the interior improvement. See exclusions in definition.	168(e)(6)
Qualified Leasehold Improvements (QLI): 2001 - 2004 Partial	9/11/01 - 10/22/04	39 Year / SL	Y	Y	Y	N/A	39 year QLI qualifies for Bonus. Landlord or lessee can make the interior improvement. See exclusions in definition.	168(e)(6)
Qualified Retail Improvement Property: 2016 - 2017	1/1/16 - 12/31/17	15 Year / SL	Y	Y	N	2010 - 2017 ⁶	Building can be owner occupied. See exclusions in definition.	168(e)(8)
Qualified Retail Improvement Property: 2009-2015	1/1/09 - 12/31/15	15 Year / SL	N ²	Y	N	2010 - 2017 ⁶	Building can be owner occupied. See exclusions in definition.	168(e)(8)
Qualified Restaurant Property: 2009 - 2017	1/1/09 - 12/31/17	15 Year / SL	N ⁴	N	N	2010 - 2017 ⁶	Encompasses the entire building structure as well as interior costs. Can be an acquired building.	168(e)(7)
Qualified Restaurant Property: 2008	1/1/08 - 12/31/08	15 Year / SL	Y	Y	N	N/A	Applicable to all improvements attached to building.	168(e)(7)
Qualified Restaurant Property: 2004-2007	10/23/04 - 12/31/07	15 Year / SL	N ³	Y	N	N/A	Applicable to all improvements attached to building.	168(e)(7)

Bonus Depreciation Rates (inclusive dates)

9/11/01 - 5/5/03 ⁸	30%
5/6/03 - 12/31/04 & 1/1/08 - 9/8/10 ⁸	50%
9/9/10 - 12/31/11 ⁸	100%
1/1/12 - 9/27/17 ⁸	50%
9/28/17 - 12/31/22 ^{8, 10, 11}	100%
1/1/23 - 12/31/23 ^{8, 10, 11}	80%
1/1/24 - 12/31/24 ^{8, 10, 11}	60%
1/1/25 - 12/31/25 ^{8, 10, 11}	40%
1/1/26 - 12/31/26 ^{8, 10, 11}	20%

Footnotes:

- 1) NOT eligible for bonus if placed in service 1/1/2005 - 12/31/2007.
- 2) Retail Improvements are not eligible for bonus depreciation unless it meets the criteria for QLI.
- 3) Qualified Restaurant Property is eligible for bonus depreciation if placed in service 10/23/2004 - 12/31/2004.
- 4) Improvements that also meet the criteria for QLI are eligible for bonus depreciation. After 2015, improvements that also meet the criteria for QIP are eligible for bonus depreciation. Restaurant property that is acquired 9/28/2017-12/31/2017 is fully expensed (subject to written binding contract rules).
- 5) Improvements that meet the definition of Qualified Improvement Property and meet the definition of QLI, Qualified Retail Improvements, or Qualified Restaurant Property can be depreciated over a 15-year straight line period.
- 6) Eligible up to \$250k from 2010 - 2015; 2016 and 2017 are subject to normal 179 expense cap.
- 7) Improvements that meet the definition of Qualified Improvement Property and meet the definition of QLI, Qualified Retail Improvements, or Qualified Restaurant Property qualify for the 179 Expense.
- 8) Long Production Period (QLIs over \$1M and construction period exceeds 1 year) - can be placed in service one year after bonus normally expires. QLI (that is also LPP) started before 1/1/2012 can be entirely eligible for 100% bonus if completed during 2012. Bonus is applicable if LPP is started before 1/1/2027. Only pre-1/1/2027 basis is bonus eligible on any LPP.
- 9) Section 179 rules are modified to include certain improvements to buildings. See 179 Expense notes on page 2.
- 10) Bonus depreciation is available for used property placed in service after 9/27/17, however it does not apply to the portion where the taxpayer previously had a depreciable interest.
- 11) Bonus is not available to taxpayers with floor plan financing (motor vehicle, boat, farm machinery) unless they are exempt from business interest limitations.

Section 179 Expense Limitations (Dates, Dollar Limit, Reduction)

01/01/11 - 12/31/17	\$500,000	\$2,000,000
1/1/18 onward ¹	\$1,000,000 ²	\$2,500,000 ²

Footnotes:

1) In 2018 onward, the Section 179 expense includes improvements to the following non-residential real property that are placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning; fire protection and alarm systems; and security systems. 179 expensing does not apply to certain non-corporate lessors. See Sec. 179(d)(5)

Qualified Section 179 property now includes depreciable tangible personal property used to furnish lodging (e.g. residential rental properties, hotels, etc).

2) Any taxable year beginning after 2018, the dollar amounts will be indexed for inflation.

Definitions:

3 Year Rule: The improvements must have been placed in service by any taxpayer more than three years after the date the building was first placed into service.

Leased Between Unrelated Party Qualification: Improvements must be made subject to a lease between unrelated parties (see code section 1504). Can be made by lessees, sub-lessees or lessors to an interior portion of a nonresidential building. Parties are related when there is more than 80% ownership shared between them.

Long Production Period Property: 168(k)(2)(B) - Must have a recovery period of at least 10 years, is subject to section 263A, has an estimated production period exceeding 2 years, or an estimated production period exceeding 1 year and a cost exceeding \$1,000,000.

Qualified leasehold improvement property (QLI)^A 2001-2017 (A) Any improvement to an interior portion of a building which is nonresidential real property if— (i) such improvement is made under or pursuant to a lease (I) by the lessee (or any sublessee) of such portion, or (II) by the lessor of such portion, (ii) such portion is to be occupied exclusively by the lessee (or any sublessee) of such portion, and (iii) such improvement is placed in service more than 3 years after the date the building was first placed in service. (B) Certain improvements not included. Such term shall not include any improvement for which the expenditure is attributable to— (i) the enlargement of the building, (ii) any elevator or escalator, (iii) any structural component benefiting a common area, and (iv) the internal structural framework of the building.

Qualified retail improvement property^A 2009-2017: Any improvement to an interior portion of a building which is nonresidential real property if— (i) such portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and (ii) such improvement is placed in service more than 3 years after the date the building was first placed in service. QRIP shall not include any improvement for which the expenditure is attributable to— (i) the enlargement of the building, (ii) any elevator or escalator, (iii) any structural component benefitting a common area, or (iv) the internal structural framework of the building.

Qualified restaurant property^B 2004-2008: an improvement to a building if— (A) Such improvement is placed in service more than 3 years after the date such building was first placed in service, and (B) more than 50 percent of the building's square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals.

Qualified restaurant property^B 2009-2017 Any section 1250 property which is (i) a building or improvement to a building — if more than 50 percent of the building's square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals, and (ii) if such building is placed in service after December 31, 2008

Qualified improvement property^A (QIP) 2016-2017: (A) Any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date the building was first placed in service. (B) Certain improvements not included. Such term shall not include any improvement for which the expenditure is attributable to— (i) the enlargement of the building, (ii) any elevator or escalator, (iii) the internal structural framework of the building.

Qualified improvement property^A (QIP) 2018-onward: (A) Any improvement *made by the taxpayer* to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date the building was first placed in service. (B) Certain improvements not included. Such term shall not include any improvement for which the expenditure is attributable to— (i) the enlargement of the building, (ii) any elevator or escalator, (iii) the internal structural framework of the building.

Other notes:

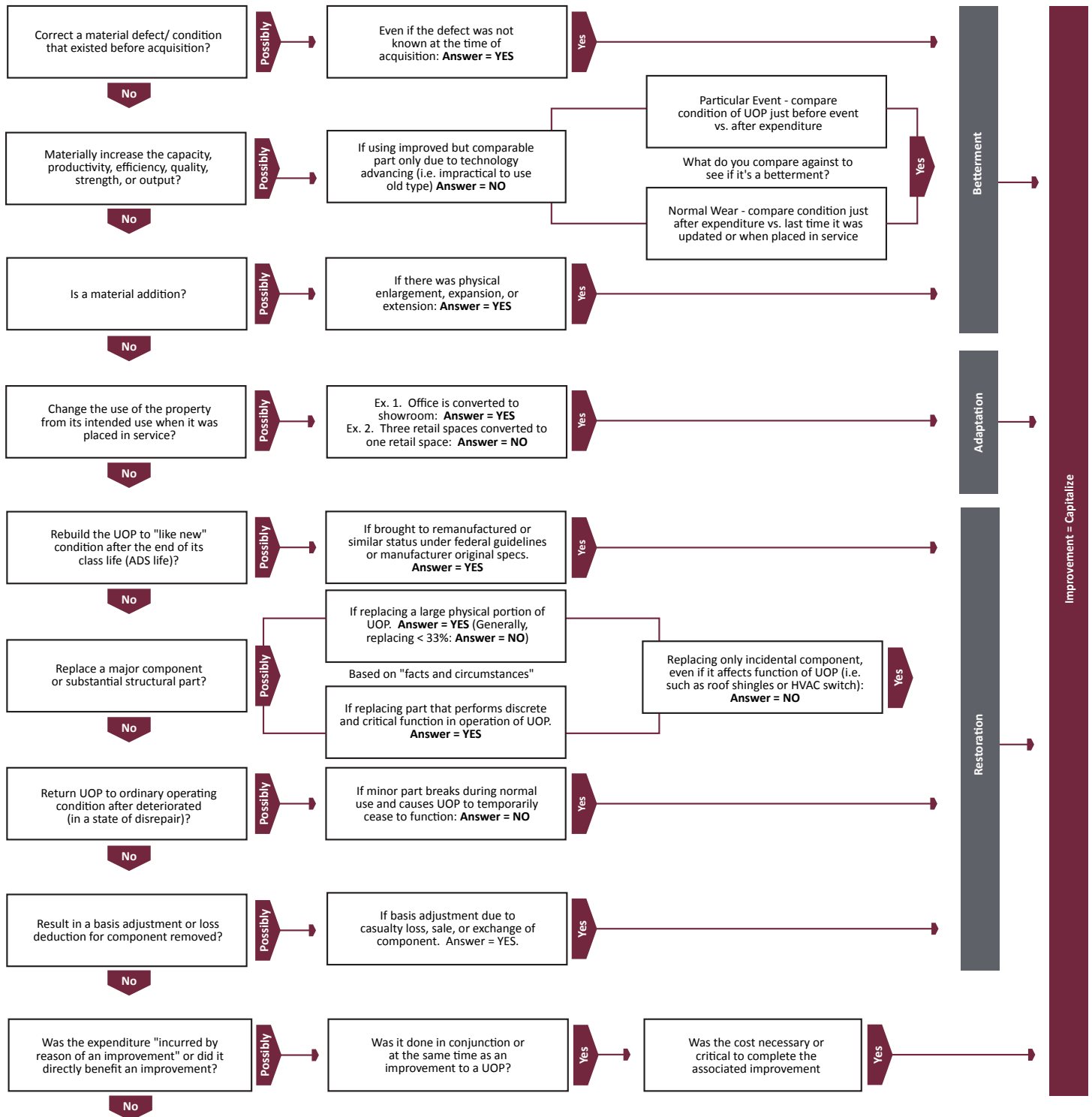
A) Tenant improvements that include costs for HVAC rooftop units are excluded from the definition of Qualified Leasehold Improvements (QLI), Qualified Retail Improvements, and Qualified Improvement Property (CCA 201310028)

B) Restaurant tenant improvements located within a multi-tenant building where 50 percent of the building's total square footage is not leased to restaurants, do not meet the definition of Qualified Restaurant Property.

KBKG REPAIR VS. CAPITALIZATION: IMPROVEMENT DECISION TREE - FINAL REGULATIONS

Considering the appropriate Unit of Property (UOP), does the expenditure:

(Last Updated 3-20-2015)



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KBKG BUILDING UNIT OF PROPERTY & MAJOR COMPONENTS CHART



This chart was created to help users identify building systems & typical "major components" in real estate assets. Replacing a major component is a capital expenditure while replacing an incidental component can be expensed

BUILDING STRUCTURE	LAND IMPROVEMENTS	HVAC SYSTEM	ELECTRICAL SYSTEM	PLUMBING SYSTEMS
<ul style="list-style-type: none"> • Roof system (membrane, insulation and structural supports) • Foundation • Other structural load-bearing elements, including stairs • Exterior wall system • Ceilings • Floors • Doors • Windows • Partitions • Loading docks 	<ul style="list-style-type: none"> • Landscaping (shrubs, trees, ground cover, lawn, irrigation) • Storm drainage (inlets, catch basins, piping, lift stations) • Site lighting (pole lights, bollard lights, up lights, wiring) • Hardscape (retaining walls, pools, water features) • Site structures (gazebos, carports, monument signs) • Paving (roads, driveway, parking areas, sidewalks, curbing) 	<ul style="list-style-type: none"> • Heating system (boilers, furnaces, radiators) • Cooling system (compressors, chillers, cooling towers) • Rooftop packaged units • Air distribution (ducts, fans, etc.) • Piping (heated, chilled, condensate water) 	<ul style="list-style-type: none"> • Service and distribution (panel boards, transformers, switchgear, metering) • Lighting (interior and exterior building mounted) • Site electrical utilities • Branch wiring (outlets, conduit, wire, devices etc.) • Emergency power systems 	<ul style="list-style-type: none"> • Plumbing fixtures (sinks, toilets, tubs etc.) • Wastewater systems (drains, waste and vent piping) • Domestic water (supply piping and fittings) • Water heaters • Site piping utilities
FIRE PROTECTION SYSTEM	SECURITY SYSTEM	GAS DISTRIBUTION SYSTEM	ESCALATORS	ELEVATORS
<ul style="list-style-type: none"> • Sprinkler systems (piping, heads, pumps) • Fire alarms (detection and warning devices, controls) • Exit lighting and signage • Fire escapes • Extinguishers and hoses 	<ul style="list-style-type: none"> • Building security alarms (detectors, sirens, wiring) • Building access and control systems 	<ul style="list-style-type: none"> • Gas piping including to/from property line and other buildings 	<ul style="list-style-type: none"> • Stairs and handrails • Drive systems (motors, truss, tracks) 	<ul style="list-style-type: none"> • Elevator cars • Drive systems (motors, lifts, controls) • Suspension systems (counterweights, framing, guide rails)

* Building unit of property (UOP) rules apply to each building structure located on a single property.

** Building system components with a different tax life are separate units of property. For example, a cost segregation study separating HVAC into 5-year & 39-year categories for a restaurant creates two separate HVAC units of property.

Lessee of Building: Must apply the same units of property above but only to the portion of the building being leased.

Personal Property: UOP are parts that are "functionally interdependent" (i.e. placing one part in service is dependent on placing the other part in service).

Plant Property: UOP is each component that performs a discrete and critical function. Generally, each piece of machinery or equipment purchased separately.

Network Assets: UOP is determined by taxpayer's particular facts

Definitions

Plant Property: Machinery and equipment used to perform an industrial process such as manufacturing, generation, warehousing, distribution, automated materials handling, or other similar activities.

Network Assets: Railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, telephone and cable lines; -- owned or leased by taxpayers in each of those respective industries.

Major Component: Part or combination of parts that performs a discrete and critical function in the operation of the unit of property.

Incidental Component: Relatively small, inexpensive, or minor part that performs a discrete and critical function for the UOP. Generally, not capitalized because of its size, cost, or significance.

KBKG is a specialty tax firm that works directly with CPAs and businesses to provide value-add solutions to our clients. Our engineers and tax experts have performed thousands of tax projects resulting in hundreds of millions of dollars in benefits. Our services include Research & Development Tax Credits, Cost Segregation, Repair vs. Capitalization 263(a) Review, IC-DISC, Green / Energy Tax Incentives (179D for Designers, 45L for Multifamily), and Fixed Asset Depreciation Review.

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**Welcome and thank you for joining KBKG's
live webinar**

**BEFORE
WE GET
STARTED**

- We will start the live webinar at **1pm PT | 4pm ET**
- For the best audio, dial in using the telephone number provided
- Please enter questions into the Q&A module
- Download the slides from **[KBKG.com/resources](https://www.kbkg.com/resources)**
 - **“R&D Tax Credit for Software Development”**



RD 300: Research & Development Tax Credits – Software Development

Download PowerPoint slides from **KBKG.com/resources**

All attendees are muted.

The webinar will begin promptly at 1 PM Pacific / 4 PM Eastern

ADMINISTRATIVE

AUDIO

- For the best sound, you should dial in and use the provided telephone number for audio.

HANDOUT MATERIALS

- Download power point slides from KBKG.com/resources

CPE (Continuing Professional Education – for CPAs only)

- Answer all polling questions during the webinar

QUESTIONS AND ANSWERS

- Please submit your questions and we will answer as many as time permits.





ABOUT KBKG



Established in 1999, KBKG is a specialty tax and consulting firm providing nationwide service:

- Research & Development Tax Credits
- R&D Audit Defense
- Cost Segregation
- Green Building Tax Incentives
- Repair & Maintenance Review
- Fixed Asset Depreciation Review
- Transfer Pricing
- IC-DISC
- Employment Tax Credits

TODAY'S PRESENTERS



Bill Taylor

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AGENDA

- **Software Development Impacts**
- **R&D Tax Credit Overview**
- **Maximizing Value for Software Industry**
- **Other Considerations**
- **Questions**



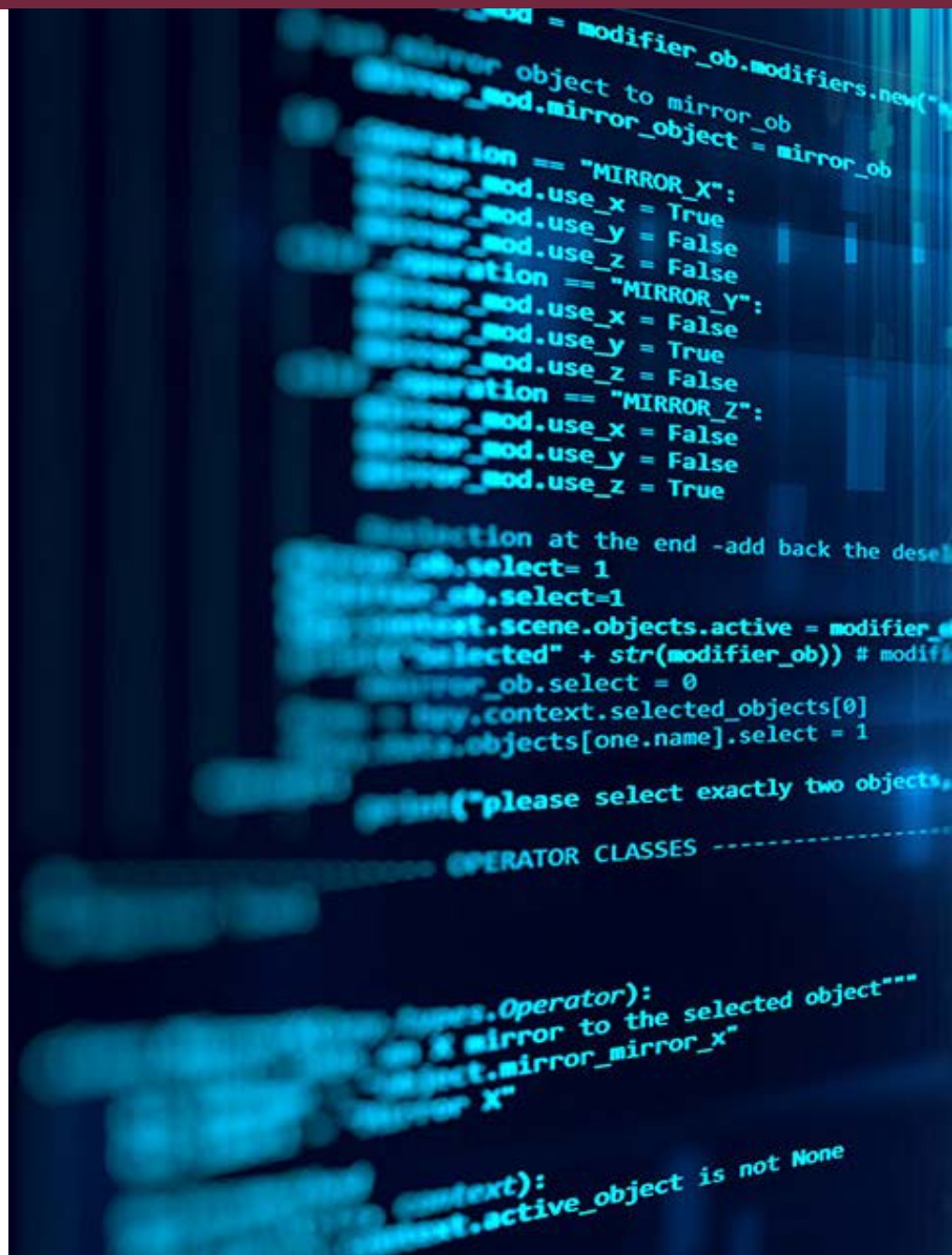
IMPACT OF SOFTWARE DEVELOPMENT

Industries:

- Aerospace & Defense
- Automotive
- Financial Services
- Healthcare
- Manufacturing
- Retail

Software Development Areas:

- Mobile Application Development
- Cyber Security
- Machine Learning
- Cloud Computing
- Natural Language Processing



OVERVIEW OF THE SOFTWARE INDUSTRY SOFTWARE DEVELOPMENT LIFE CYCLE

Requirements Analysis & Specification

- Communication gaps could result in validation errors & bugs

Design / Coding

- Detailed functions & operations, screen layouts, business rules, process diagrams

Implementation / Product Release

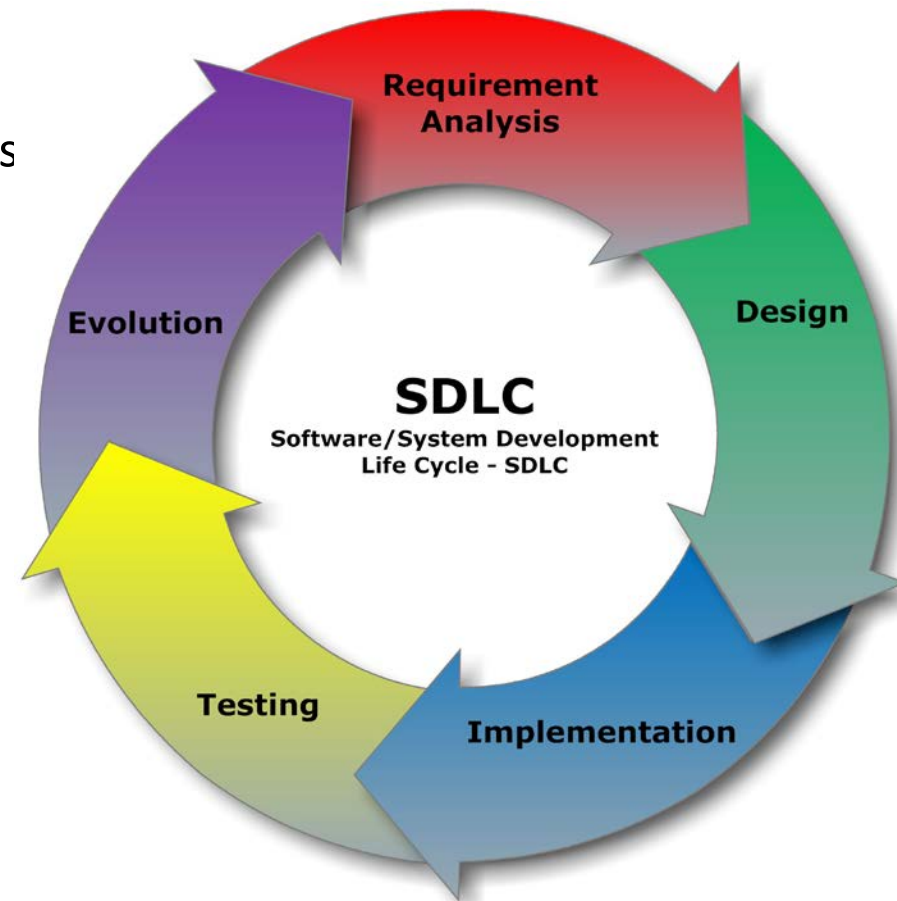
- Modular and subsystems code, unit & module testing conducted

Testing

- Unit, system & user acceptance is conducted

Evolution

- Software revisions for next generation





POLLING QUESTION #1



R&D TAX CREDIT OVERVIEW

R&D TAX CREDIT OVERVIEW

BENEFITS OF THE R&D TAX CREDIT

- Federal Tax Benefit: 7% to 10% of Qualified Research Expenses (QRE)
- Dollar-for-Dollar reduction in tax liability
- Provides cash relief needed to increase R&D activities, launch new software products, improve internal processes, hire additional engineers, secure patents, etc.
- Increases the Return on Investment
- Lowers the effective tax rate
- Improves earnings per share
- Retroactive Claims (all open years or more if net operating losses)
- General Rule: 1 Year Carryback; 20 Year Carryforward
- S Corps & Partnerships – R&D tax credit flows through to the owners
- Many states offer an R&D tax credit

R&D TAX CREDIT OVERVIEW R&D 4-PART TEST

01

02

03

04

1. Technological in Nature (§ 41)

The activity performed must fundamentally rely on principles of:

- Physical Science;
- Biological Science;
- Engineering; or
- Computer Science

2. Permitted Purpose (§ 41)

The activity must relate to a new/improved business component's:

- Function;
- Performance;
- Reliability; or
- Quality

3. Elimination of Uncertainty (§ 174)

The activity must be intended to discover information to eliminate uncertainty concerning the capability, method or design for developing or improving a product or process.

4. Process of Experimentation (§ 41)

The taxpayer must engage in an evaluative process designed to identify and evaluate more than one alternative to achieve a result.

For example: modeling, simulation or a systematic trial and error methodology.

R&D TAX CREDIT OVERVIEW R&D 4-PART TEST: SOFTWARE DEVELOPMENT

01

02

03

04

1. Technological in Nature (§ 41)

The activity performed must fundamentally rely on principles of:

- Computer Science
- Software Engineering

2. Permitted Purpose (§ 41)

- Programming for new modules, improved performance, increased speed, higher accuracy, enhanced features, new requirements, improved stability, etc.
- Intent is key

SUCCESS IS NOT REQUIRED

3. Elimination of Uncertainty (§ 174)

Appropriate technology, optimal system performance, architecture, programming languages, effect on other modules, systems, apps, etc.

4. Process of Experimentation (§ 41)

Evaluate alternative system designs, architectures, algorithms, new database management techniques, etc.

Experiment with programming code, revising as necessary as the result of functional testing on the feature, module and system or platform levels.

R&D TAX CREDIT OVERVIEW

QUALIFIED RESEARCH EXPENSES

Wages

- (1) W-2, Box 1; (2) Partnership Earnings subject to SE tax; & (3) Schedule C
- Excludes 401k & pre-tax benefits, and wages used to calculate Work Opportunity Credit under §51

Supplies – Typically do not apply to software industry

- Tangible property used or consumed in qualified research activities, excludes:
- (i) Land – acquisition & improvements; & (ii) Depreciable

Contract Research

- 65% of amounts paid to non-employees for qualified activities

Rental/Lease of Computers/Cloud Computing

R&D TAX CREDIT OVERVIEW

WHO QUALIFIES?

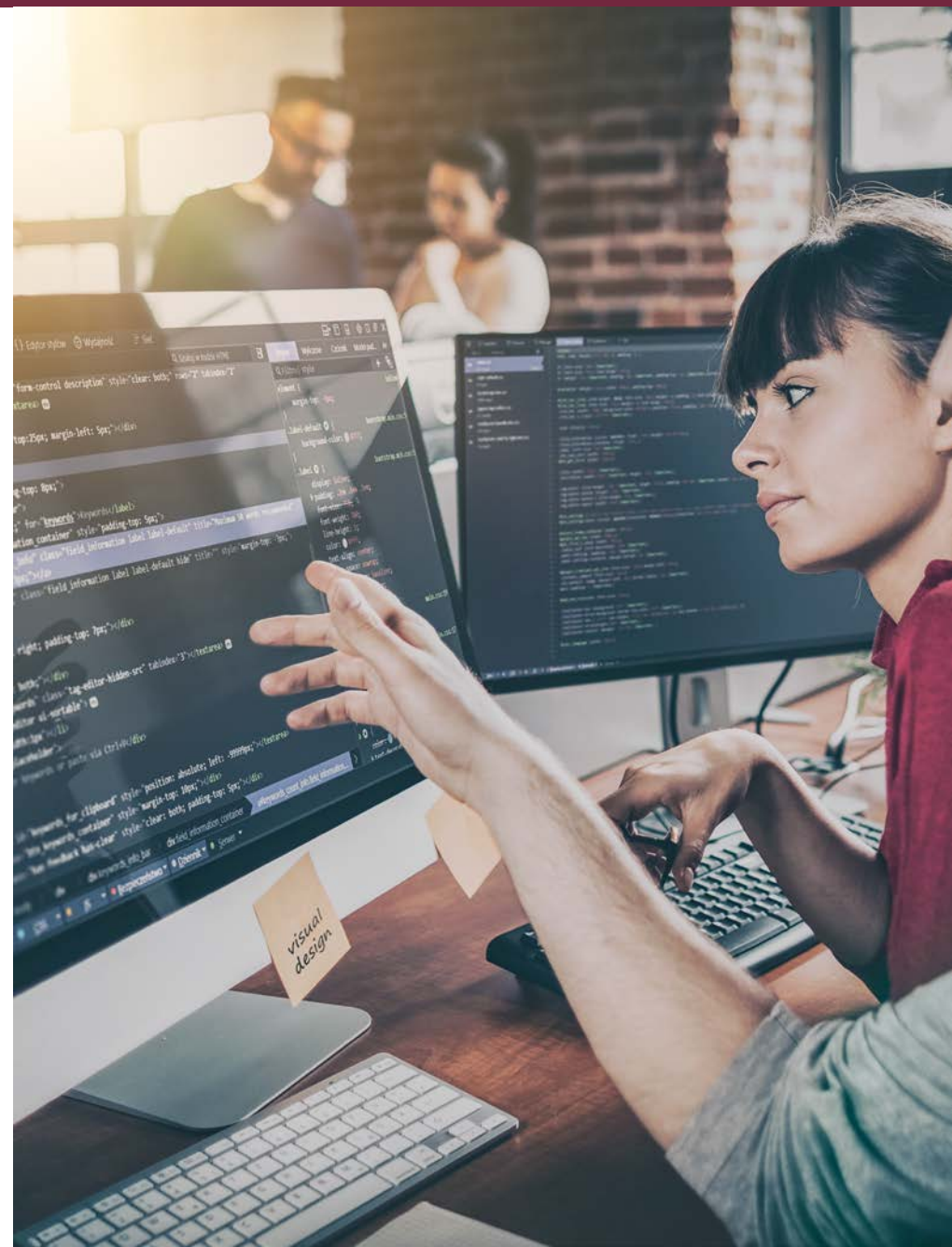
Any Employee who:

- Performs qualified activities
- Direct Supervision of other employees who perform qualified activities
- Direct Support of other employees who perform qualified activities

Outside Contract Service Providers:

- 65% of amounts paid or incurred for qualified research (paid to any person other than an employee of the taxpayer)

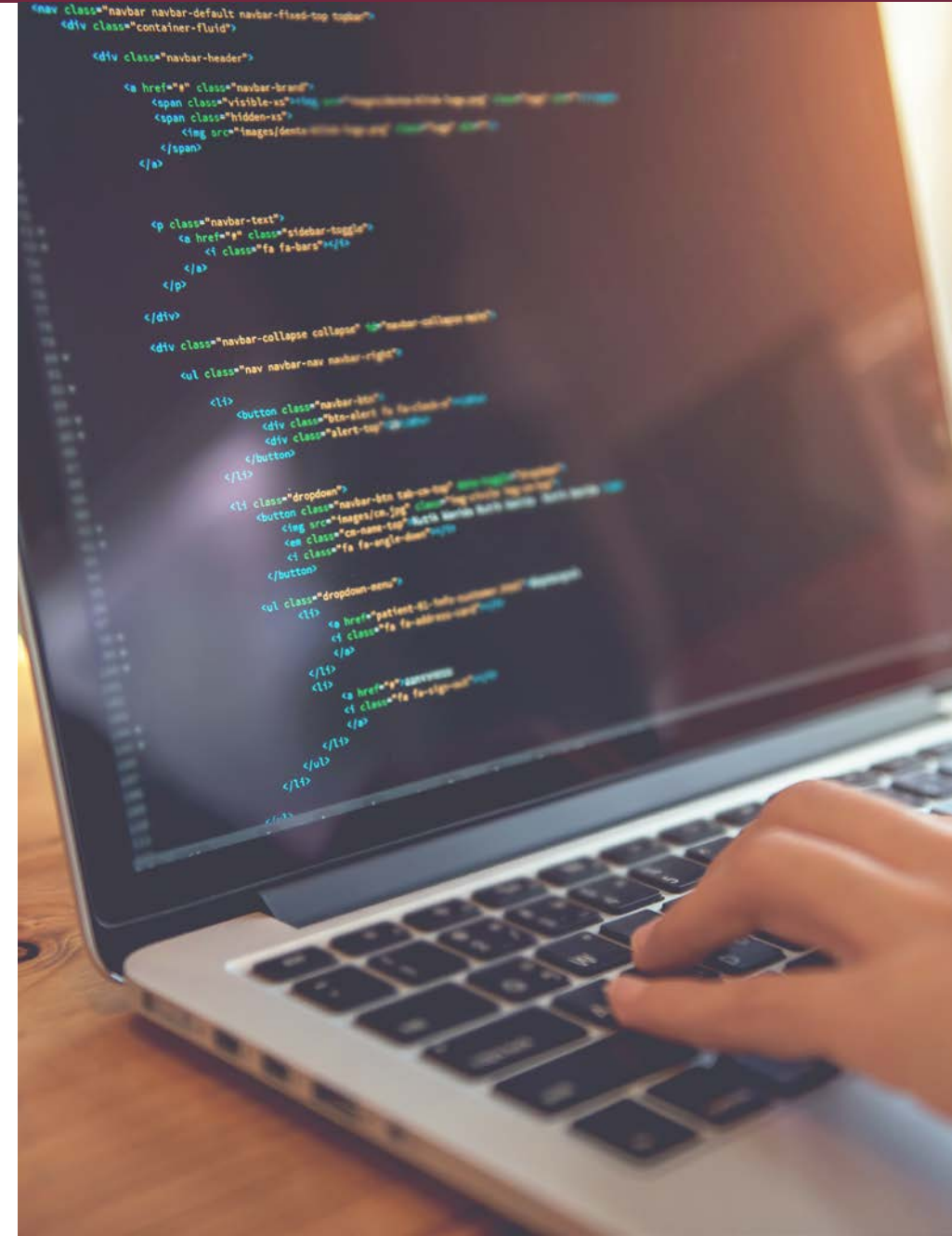
Qualified activities must be performed in the United States



R&D TAX CREDIT OVERVIEW

QUALIFIED SOFTWARE ACTIVITIES

- Develop new or improved technologies
- Design and develop software architecture
- Establish functional relationships between software modules
- Program and test software source code
- Conduct unit, integration, functional, performance, and regression testing
- Develop feature enhancements
- Conduct analysis for new functional software end requirements, domain, software elements, or scope analysis for a new functional software enhancement
- Evaluate and establish functional specifications
- *Many more....*



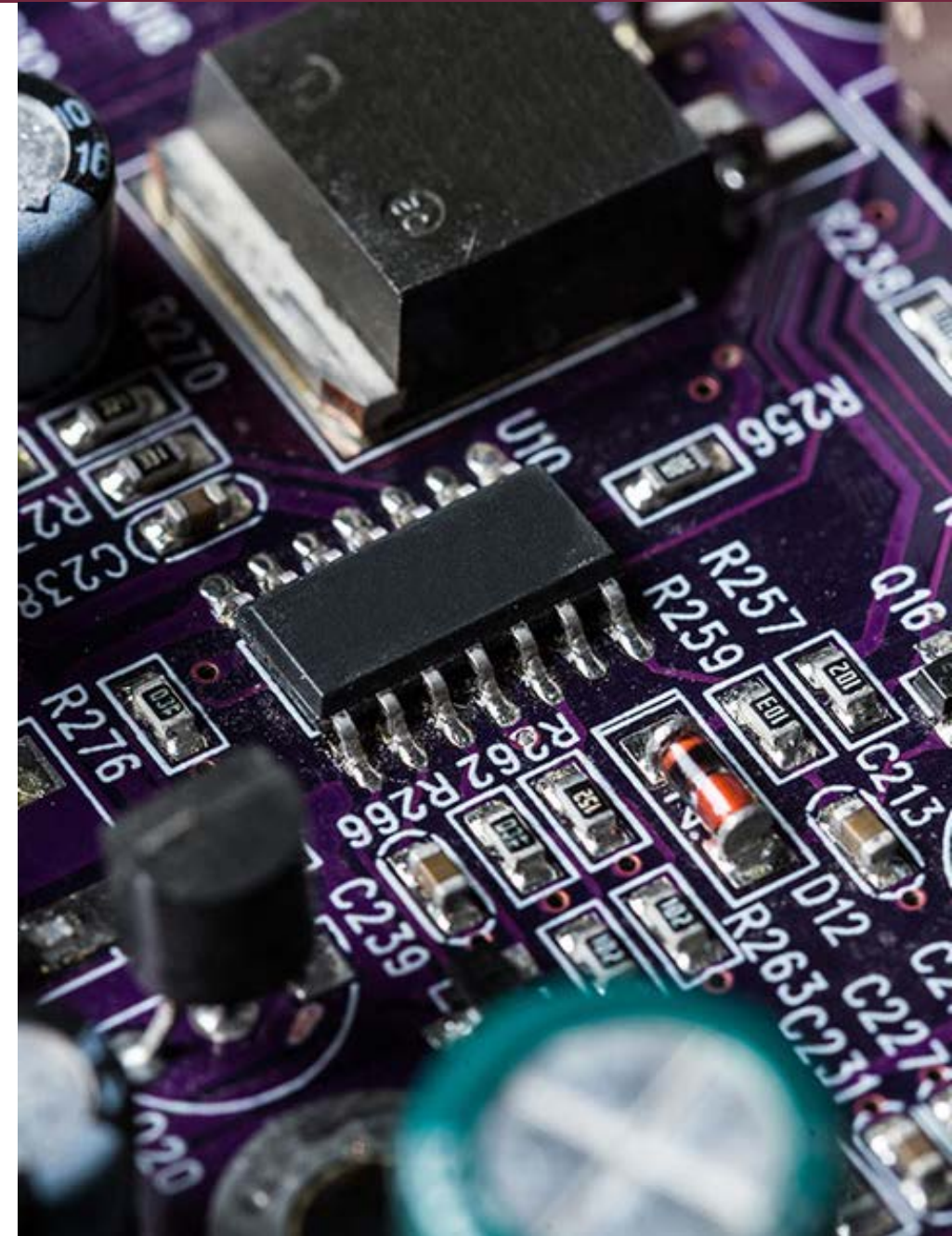
R&D TAX CREDIT OVERVIEW NON-QUALIFIED ACTIVITIES

- Routine maintenance of existing software applications or products
- Software application configuration
- Reverse engineering
- Performing studies or activities to select vendor products
- Upgrading to newer versions of hardware or software or installing vendor fix releases
- Data quality, data cleansing, and data consistency activities
- Bundling existing individual software products into product “suites”



R&D TAX CREDIT OVERVIEW INTERNAL USE SOFTWARE FINAL REGULATIONS

- Definition of Internal Use Software (IUS)
 - Connectivity software
 - Dual function software
 - Safe harbor
 - Third party definition
- High Threshold of Innovation Test
 - Software is innovative
 - Involved significant economic risk
 - Software is not commercially available
- The final regulations are prospective in nature



R&D TAX CREDIT OVERVIEW

EXAMPLE: INTERNAL USE SOFTWARE

A Salt Lake City-based company created a new billing system to replace its legacy system. The new system would automate several manual functions. Although it would have some client-facing features, it was primarily intended for internal use.

Started Operations: 2005

Number of Software Engineers: 4

Employee Wages: \$4,600,000

Qualified Wages: \$200,000

2022 Federal Credit: \$20,000

2022 Utah Credit: \$20,000

Qualified Project:

- Programmed modules to allow improved customer and vendor access to data within the company's database
- NOTE: Since this new billing system was considered dual use software, only the portion of the development dedicated to client-facing features and functionality were captured as qualified expenses.

Total of \$40,000 in federal & state credits for 2022.





POLLING QUESTION #2

R&D TAX CREDIT OVERVIEW

THE PATH ACT (2015)

The PATH Act made **THREE** major enhancements to the R&D Tax Credit

- Permanent Extension
- Payroll Tax Offset up to \$250,000*
- Alternative Minimum Tax (AMT)
 - *Reminder: The Corporate AMT was repealed, and the Individual exemption amounts were increased for tax years beginning after December 31, 2017 (Tax Cuts & Jobs Act, H.R. 1)*

**Increases to \$500,000 for tax years beginning after December 31, 2022*



R&D TAX CREDIT OVERVIEW

EXAMPLE: PAYROLL TAX OFFSET

ABC Software began operations in 2021 and is developing a new gaming app.
The company is a pre-revenue start-up operating as an S-Corp and has 15 employees.

Summary of 2022:

- Gross Receipts - \$0
- Qualified Wages - \$2,000,000
- R&D Credits - \$200,000
- Qualified Payroll Taxes - \$125,000

The Company filed its 2022 tax return in April 2023 and will apply the credits to its payroll taxes in the 3rd quarter of 2023. Unused credits will be carried forward to the 4th quarter of 2023.



Before law change R&D Credit Utilization = \$0
After law change R&D Credit Utilization = \$125,000

R&D TAX CREDIT OVERVIEW

EXAMPLE: GAMING SOFTWARE

An Atlanta-based software company created a new gaming software for a popular video game series.

Started Operations: 2021

Number of Software Engineers: 10

Employee Wages: \$1,400,000

Qualified Wages: \$800,000

2022 Federal Credit: \$73,000

2022 Georgia Credit: \$62,000

Total of \$135,000 in federal & state credits for 2022.
Able to offset payroll tax with R&D credits.



Qualified Projects:

- Programmed software to animate gaming assets
- Designed and coded custom 3D graphics and animation as well as sound effects
- Designed a proprietary motion capture software for realistic game character animation
- Developed a game networking architecture for multiplayer online games

R&D TAX CREDIT OVERVIEW

EXAMPLE: SOFTWARE AS A SERVICE (SAAS)

An Indianapolis-based software company developed a new cloud-based enterprise resource planning (ERP) software, which it licenses to customers on a subscription basis.

Started Operations: 2015

Number of Software Engineers: 12

Employee Wages: \$2,500,000

Qualified Wages: \$1,000,000

Taxable Position: Pays regular tax

Payroll Tax Credit: Ineligible (> 5 years)

2022 Federal Credit: \$100,000

2022 Indiana Credit: \$76,000

Qualified Projects:

- Programmed code to add new search functions, improved speed for data retrieval and generation of customizable reports
- Developed new application controls to improve data security
- Designed a new user-friendly mobile app for access via tablet or smartphone



**Total of \$176,000 in federal & state credits for 2022.
Unable to offset payroll tax with R&D credits.**

R&D TAX CREDIT OVERVIEW

EXAMPLE: AMT TAX OFFSET

R&D Tax Credit Utilization for tax years beginning 1/1/2016

2022 R&D Tax Credit Generated	= \$ 331,000
2022 Total Tax Liability	= \$ 219,000*
* 2022 Regular Tax Liability	\$ 188,000
* 2022 AMT Liability	<u>\$ 31,000</u>
Total	\$ 219,000

2022 R&D Credit Utilization = \$ 178,250

2022 Total Tax Liability after Credit = \$ 40,750



Total Tax Savings = \$178,250

Prior to PATH ACT Changes Total Tax Savings Would = 0

R&D TAX CREDIT OVERVIEW

EXAMPLE: FINANCIAL SERVICES SOFTWARE

An Austin-based software company developed software tools designed to help banks, loan offices and investment firms perform their job functions, stay compliant with federal and state regulations and better service their clients.

Started Operations: 2021

Number of Software Engineers: 10

Employee Wages: \$1,500,000

Qualified Wages: \$750,000

Taxable Position: **Not profitable**

Payroll Tax Credit: Eligible

2022 Federal Credit: \$75,000

2022 Texas Credit: \$24,000

Qualified Projects:

- Programmed code to create a new lending platform to allow lenders to access data easier, view and share loan data and order services
- Designed a new compliance management software, allowing clients to streamline audit processes, provide improved visibility to customer documents and respond more quickly and accurately to customer concerns



Total of \$99,000 in federal & state credits for 2022. Able to offset payroll tax.

OVERVIEW OF THE SOFTWARE INDUSTRY

EXAMPLE: DATA SCIENCE SOFTWARE

A Chicago-based software company created a new data science platform used by data scientists, data analysts and engineers to prototype, build and deliver their data products.

Started Operations: 2010

Number of Software Engineers: 23

Employee Wages: \$3,500,000

Qualified Wages: \$2,000,000

Taxable Position: Pays Regular Tax

Payroll Tax Credit: Ineligible (> 5 years)

2022 Federal Credit: \$200,000

2022 Illinois Credit: \$52,000

Qualified Projects:

- Programmed code to optimize communication of data to over 20 data storage systems
- Designed a system enabling customers to detect fraud with predictive analytics.
- Programmed applications so customers could import data, use various proprietary modules to analyze various data sets across multiple platforms and from various devices



Total of \$252,000 in federal & state credits for 2022.

R&D TAX CREDIT OVERVIEW

EXAMPLE: SALES & MARKETING SOFTWARE

A Los Angeles S Corp created software to manage prospecting activities in a single place, providing tools to efficiently manage the sales pipeline and automating sales campaigns.

Started Operations: 2019

Number of Software Engineers: 13

Employee Wages: \$2,500,000

Qualified Wages: \$1,300,000

Taxable Position: Owner pays AMT

Payroll Tax Credit: Eligible

2022 Federal Credit: \$156,000

2022 California Credit: \$97,000

Qualified Projects:

- Programmed code to automate manual data entry tasks
- Designed a system enabling customers access to data from various email accounts, content management systems, voicemail and call logs
- Programmed a pipeline management system with improved security and alert notification capability



Total of \$253,000 in federal & state credits for 2022.

Owner able to offset AMT and payroll tax with R&D credits.

R&D TAX CREDIT OVERVIEW

EXAMPLE: SOFTWARE IN HARDWARE

A Philadelphia-based company manufactures kiosks and ATMs for airports, shopping malls and convention centers. Its software engineers develop the software that goes inside its kiosks.

Started Operations: 2008

Number of Software Engineers: 14

Employee Wages: \$2,500,000

Qualified Wages: \$1,300,000

Taxable Position: Pays Regular Tax

Payroll Tax Credit: Ineligible (> 5 years)

2022 Federal Credit: \$135,000

2022 Pennsylvania Credit: \$65,000

Qualified Projects:

- Programmed code to improve security through enhanced encryption
- Developed proprietary software for robotics equipment on the production line
- Programmed code to allow access to multiple applications without exiting the main dashboard



**Total of \$200,000 in federal & state credits for 2022.
Unable to claim the credit against payroll tax.**



POLLING QUESTION #3



MAXIMIZING VALUE FOR THE SOFTWARE INDUSTRY

MAXIMIZING VALUE FOR SOFTWARE INDUSTRY SOFTWARE DEVELOPMENT EXAMPLES

- Mobile apps
- Software in hardware
- Manufacturing process control software
- Data science software
- Accounting and financial software
- Logistics management software
- Security software
- Claims processing software
- Content management software
- Database management software
- Video games and game creation software
- Medical and healthcare management software
- Sales and marketing software
- Software as a Service (SaaS)



MAXIMIZING VALUE FOR SOFTWARE INDUSTRY: ADDITIONAL BENEFITS

There are often additional benefits not fully claimed by many Software Development companies that may include:

- Bonuses, Stock Compensation and K-1 income, subject to SE Tax
- Contract Research
- High-Level Executives
- Job Titles
- Employees outside of the core software development departments
- Software development for customers
- Internally-funded software projects
- Internal-use software
- Cloud computing server rental expenses

The Key is Substantiation





OTHER CONSIDERATIONS

IRS AUDIT CONSIDERATIONS

IRS Chief Counsel Memorandum 20214101F

- Currently applies to amended or not timely filed returns
- Requires additional information to be submitted for a claim to be considered “valid”:
 - Identify all the business components to which the I.R.C. § 41 research credit claim relates for that year.
 - For each business component: identify all research activities performed; identify all individuals who performed each research activity; and identify all the information each individual sought to discover



IRS AUDIT CONSIDERATIONS

Upcoming Sec 174 changes (effective 1/1/2022)

The new rules will require specified R&E expenditures to be capitalized and amortized beginning at the midpoint of the tax year incurred, over:

- 5 years for expenditures associated with the research conducted in the United States
- 15 years if research is conducted outside the United States
- Software development costs will be defined as specified R&E expenditures under IRC 174
- 3115 Adjustment will be required

Audit Technique Guide (ATG) outlines the areas agents will focus on when conducting their audits of R&D credit claims

- Highly-Compensated Employees
- Funded Research
- Contemporaneous Documentation
- Process of Experimentation

OTHER CONSIDERATIONS CONTEMPORANEOUS DOCUMENTATION

- Initiation & Concept Development
- Concept Proposal
- Systems Boundary Document
- Cost Benefit Analysis
- Risk Management Plan
- Feasibility Study
- Planning & Requirements Analysis
- Project Management Plan
- Functional Requirements
- Design & Development
- Systems Design Document
- Source Code Samples
- Test Readiness Review
- Revision Notes / Release Notes
- Screen Layouts
- Process Diagrams
- Integration & Testing
- Quality Assurance Test Procedures
- Test Analysis Reports
- Recommendations for Redesign
- Implementation
- Trouble-shooting Documents
- Lessons Learned
- Other Documents
- Patents / Patent Applications
- User Guides
- Technical Meeting Agenda / Minutes
- Emails Detailing Technical Issues



POLLING QUESTION #4



SOLUTIONS FOR TAX PROFESSIONALS AND BUSINESSES

TAX CREDITS • INCENTIVES • COST RECOVERY

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