

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:

- NOT eligible for bonus if placed in service 1/1/2005 - 12/31/2007.
- Retail Improvements are not eligible for bonus depreciation unless it meets the criteria for QLI.
- Qualified Restaurant Property is eligible for bonus depreciation if placed in service 10/23/2004 - 12/31/2004.
- 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).
- 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.
- Eligible up to \$250k from 2010 - 2015; 2016 and 2017 are subject to normal 179 expense cap.
- 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.
- 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.
- Section 179 rules are modified to include certain improvements to buildings. See 179 Expense notes on page 2.
- 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.
- 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:

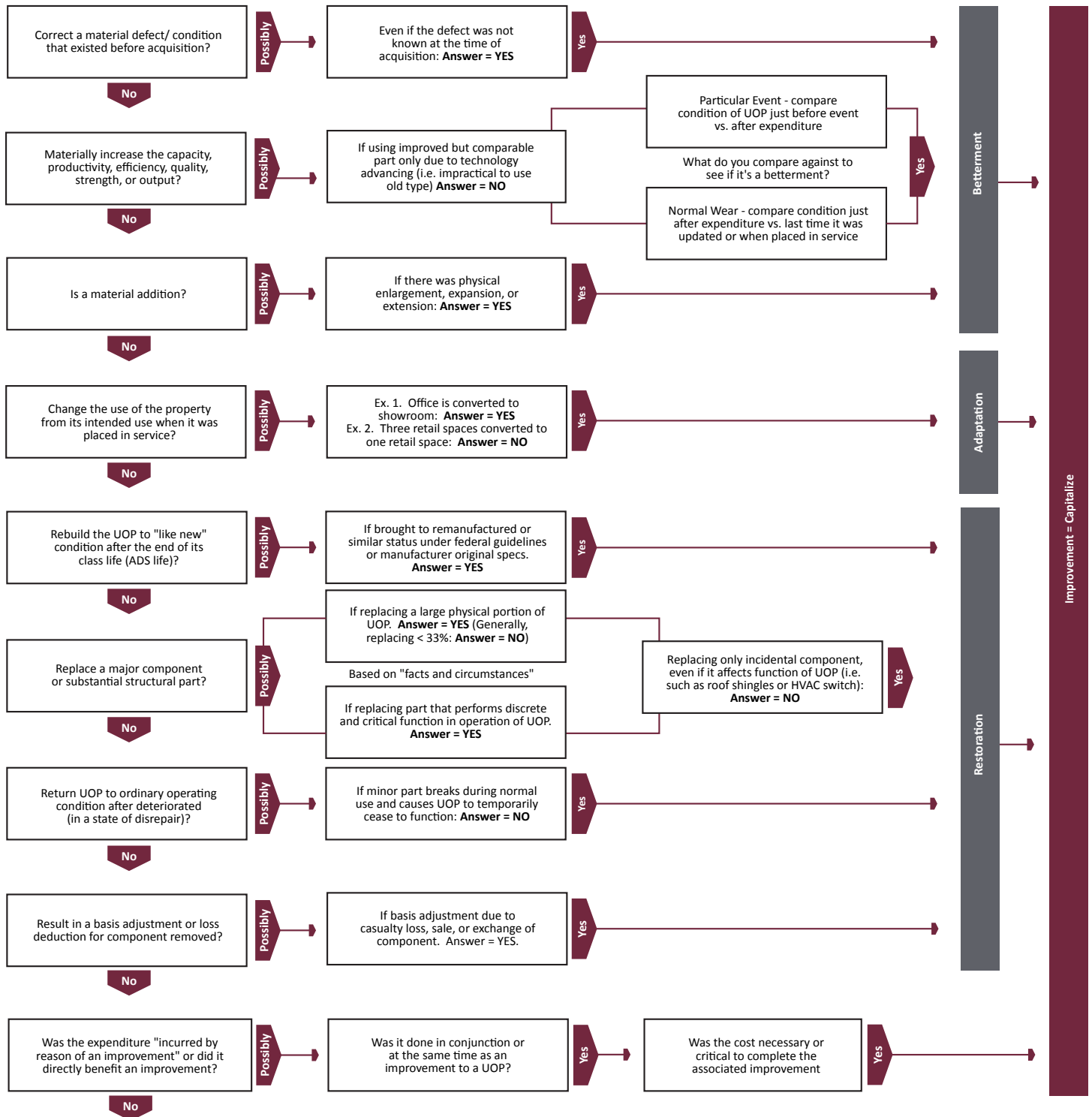
A) Tenant improvements that include costs for HVAC rooftop units are excluded from the definition of Qualified Leasehold Improvements (QLI), Qualified Retail Improvements, and Qualified Improvement Property (CCA 201310028)

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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BEFORE WE GET STARTED

Welcome and thank you for joining KBKG's live webinar

- We will start the live webinar at **1 pm PT | 4 pm 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**
 - **“R&D Tax Credits and the IRS: How to Prepare for Audit”**



R&D TAX CREDITS AND THE IRS: HOW TO PREPARE FOR AUDIT

What you will likely encounter in an examination of this issue

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

All attendees are muted.

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



ADMINISTRATION

AUDIO

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

HANDOUT MATERIALS –

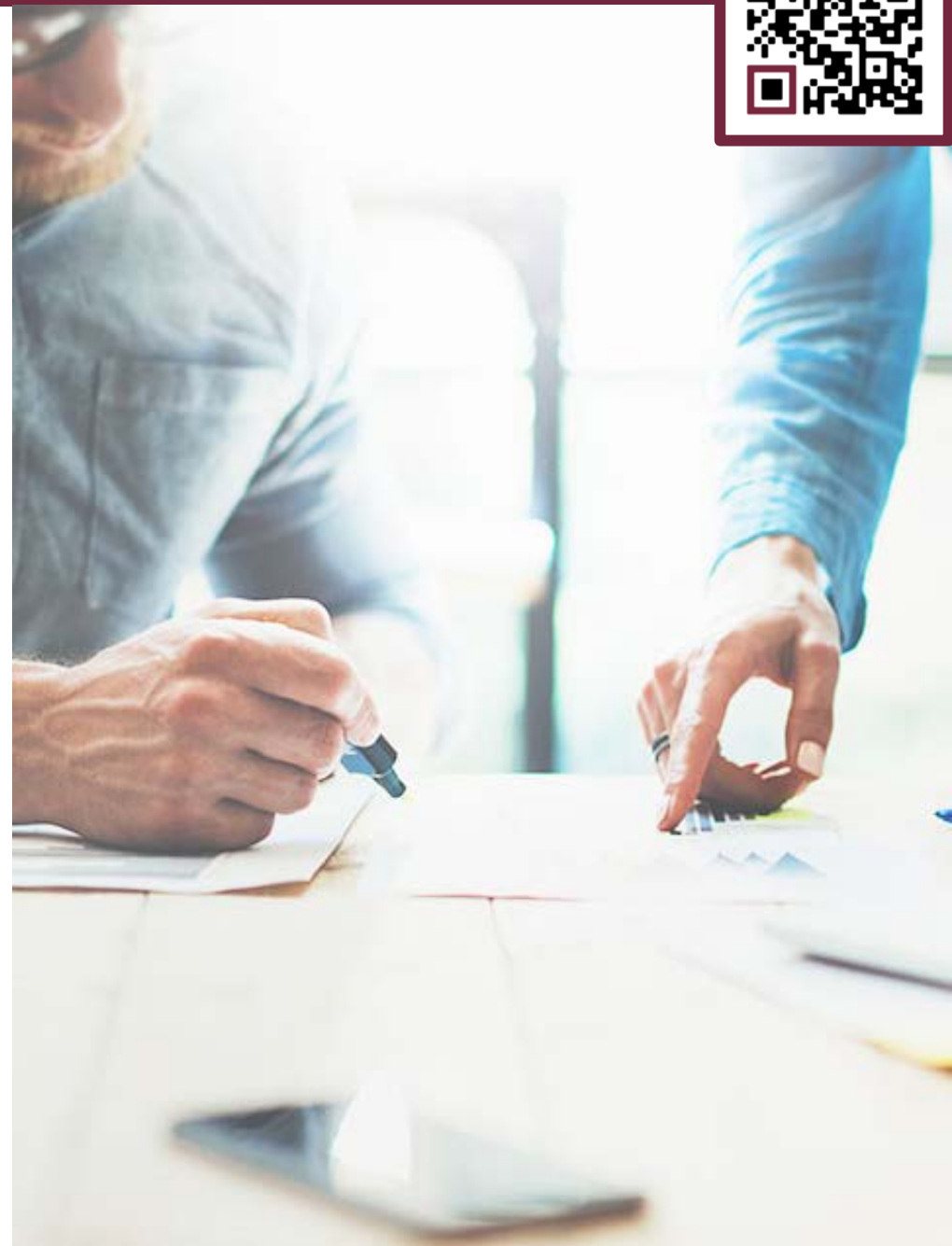
- Download power point slides from KBKG.com/resources


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



JONATHAN TUCKER

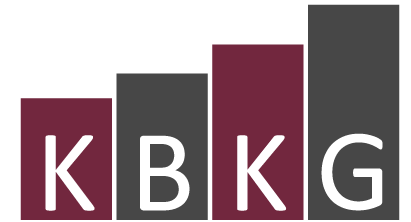


- **Over 18 years of experience**
 - Providing federal business tax advisory services, primarily in R&D tax credits and fixed asset/cost segregation review
- **15 years with EY and PwC**
 - 4 years at EY as a senior manager in their business tax advisory group
 - 11 years at PwC as a director in their specialized tax services group
- **University of Georgia**
 - Bachelors degree in Accounting
 - Masters degree in Accounting





JACK JOLLY



- **11 years as an engineer for Dept of Defense**
 - 5 years in combat vehicle powertrain overhaul
 - 6 years on a research project that became a production facility
- **21 years with the IRS**
 - 5 years as an engineer supporting audits
 - 11 years as an engineering team manager
 - 3 years as an engineering territory manager
 - 2 years as a senior analyst for engineering
- **University of Alabama at Birmingham**
 - Mechanical Engineering





MARK BODENSTAB



- Director at KBKG
- Over 20 years in the Industrial Gas Industry
- **14 years with the IRS**
 - Engineer supporting audits
 - Engineering team manager
 - Staff assistant to the Director of Field Operations
- Union College in Schenectady New York
 - Bachelor of Science, Civil Engineering





AGENDA

- Who conducts IRS Audits?
- How does the IRS select returns for Audit?
- How does an IRS Audit begin?
- IRS specialist involvement in R&D Credit Audits
- IRS guidance on the R&D Credit Issue
- IRS initiatives on the R&D Credit Issue
- Differences in LB&I vs SBSE Audits
- What is Qualified Research for the Credit?
- Likely focus areas in an Audit of the R&D Credit Issue
- R&D Credit Issue Resolution
- Appeals
- Additional IRS Audit related programs
- Taxpayer Rights





WHO CONDUCTS IRS AUDITS?

There are four divisions in the IRS auditing tax returns

- Wage and Investment (W&I)
- Tax exempt and government entities (TEGE)
- Small business and self-employed (SBSE)
- Large business and International (LB&I)

The Research & Development Tax Credit issue is audited by SBSE and LB&I personnel





AN SBSE AND LB&I COMPARISON

SBSE and LB&I have different procedures and directives

- Some sections of the Internal Revenue Manual (IRM) are applicable to both, but both have specific sections that do not apply to the other division.

SBSE

LB&I

Taxpayer assets < \$10M	Taxpayer assets > \$10M
Single revenue agent	Single/multiple revenue agents
Specialist involvement unlikely	Specialist involvement likely
12 to 18-month timeline	18 to 30-month timeline



POLLING QUESTION #1



HOW DOES THE IRS SELECT RETURNS FOR AUDIT?

Specifically, will claiming the R&D Credit trigger an audit?

- Discriminate Inventory Function (DIF)
- Compliance Initiative Projects (CIP)
- Abusive transactions (tax shelters)
- Listed transactions
- Preparer projects
- Promoter projects
- Filters
- Classification
- Amended returns (claims)





HOW DOES AN IRS AUDIT BEGIN?

- Revenue agent manager (case manager) orders returns
- Returns reviewed for potential issues
- Returns assigned to revenue agents
- Revenue agent reviews return to identify potential issues
- Revenue agent reviews available public information
- Revenue agent contacts taxpayer





IRS SPECIALIST INVOLVEMENT IN R&D CREDIT AUDITS

- Specialist Referral System
- Engineers
- Computer Audit Specialists (CAS)
 - Statistical Sampling Coordinator
- Business Credit practice area RC subject matter experts (SME)
- Local Counsel
- National Counsel





IRS SPECIALIST INVOLVEMENT IN R&D CREDIT AUDITS

- Engineer is most likely to be involved
- IRS engineers are part of LB&I but support all of IRS
- IRS engineers have degrees in numerous engineering disciplines
- Many IRS engineers have graduate degrees
- LB&I > 90% issue assigned to engineer
- SBSE <5% issue assigned to an engineer
- SBSE <5% engineer consults on issue with revenue agent





IRS SPECIALIST INVOLVEMENT IN R&D CREDIT AUDITS

- CAS is next most likely to be involved
- CAS are part of LB&I
- CAS are typically revenue agents with specialized training.
- They assist with retrieving and analyzing electronic data from taxpayers
- R&D Credit involvement is usually related to a statistical sample
- They review taxpayers' samples for Rev Proc 2011-42 compliance
- They create sampling plans for revenue agents and engineers
- Statistical sampling coordinator may assist or advise





IRS SPECIALIST INVOLVEMENT IN R&D CREDIT AUDITS

- SMEs receive requests from revenue agents for guidance
- LB&I SMEs are part of Business Credit Practice Group
- They were formally called Technical Advisors
- SBSE RC SME is still a Technical Advisor
- There are also SBSE analysts dedicated to R&D Credit issue





IRS SPECIALIST INVOLVEMENT IN R&D CREDIT AUDITS

- IRS Counsel may become involved at the request of:
 - The revenue agent
 - Another specialist
 - The taxpayer or their representative
- Both LB&I & SBSE have local and national counsel
- Attorneys from National counsel will have R&D Credit expertise





IRS GUIDANCE ON THE R&D CREDIT ISSUE

- Congress writes the law, IRC §41
 - Credit was made permanent in the Protecting Americans from Tax Hikes (PATH) Act of 2015
- Treasury writes the regulations
 - Proposed regulations
 - Temporary regulations
 - Final regulations
- Notice of proposed rulemaking
 - Electronic reading room
 - Public comments





IRS GUIDANCE ON THE R&D CREDIT ISSUE

- IRS counsel and SMEs interpret law and regulations
- Audit Techniques Guides (ATGs)
 - General RC ATG
 - RC claims ATG
 - Software audit guidelines
 - Aerospace Industry Research Credit ATG
 - Pharmaceutical Research Credit ATG
- LB&I Practice Units
- Accounting Standards Codification (ASC) 730 Directive - Computing Qualified Research Expenses
- SBSE Technical Advisors





IRS GUIDANCE ON THE R&D CREDIT ISSUE

The R&D Credit issue in the courts

There are two types of tax cases:

- Tax Court cases
 - Judges only hear tax related cases
 - Tax Court Memorandum cases not reviewed by all judges
 - Taxpayers do not pay tax prior to court
- District Court cases
 - Taxpayers pay tax and sue for a refund
 - Decision sets precedent only within that district





IRS GUIDANCE ON THE R&D CREDIT ISSUE

There are over 60 court cases addressing these R&D Credit issues and others

The R&D Credit issue in the courts

Trade or Business Requirement	Partnership or Partner Level
Business Component	Four Part Test
Limitation on Internal Use Software	Limitation on Funded Research
Wages and Supplies	Reasonable Expenses
Limitation on Depreciable Property	Gross Receipts
Base Period	Substantiation

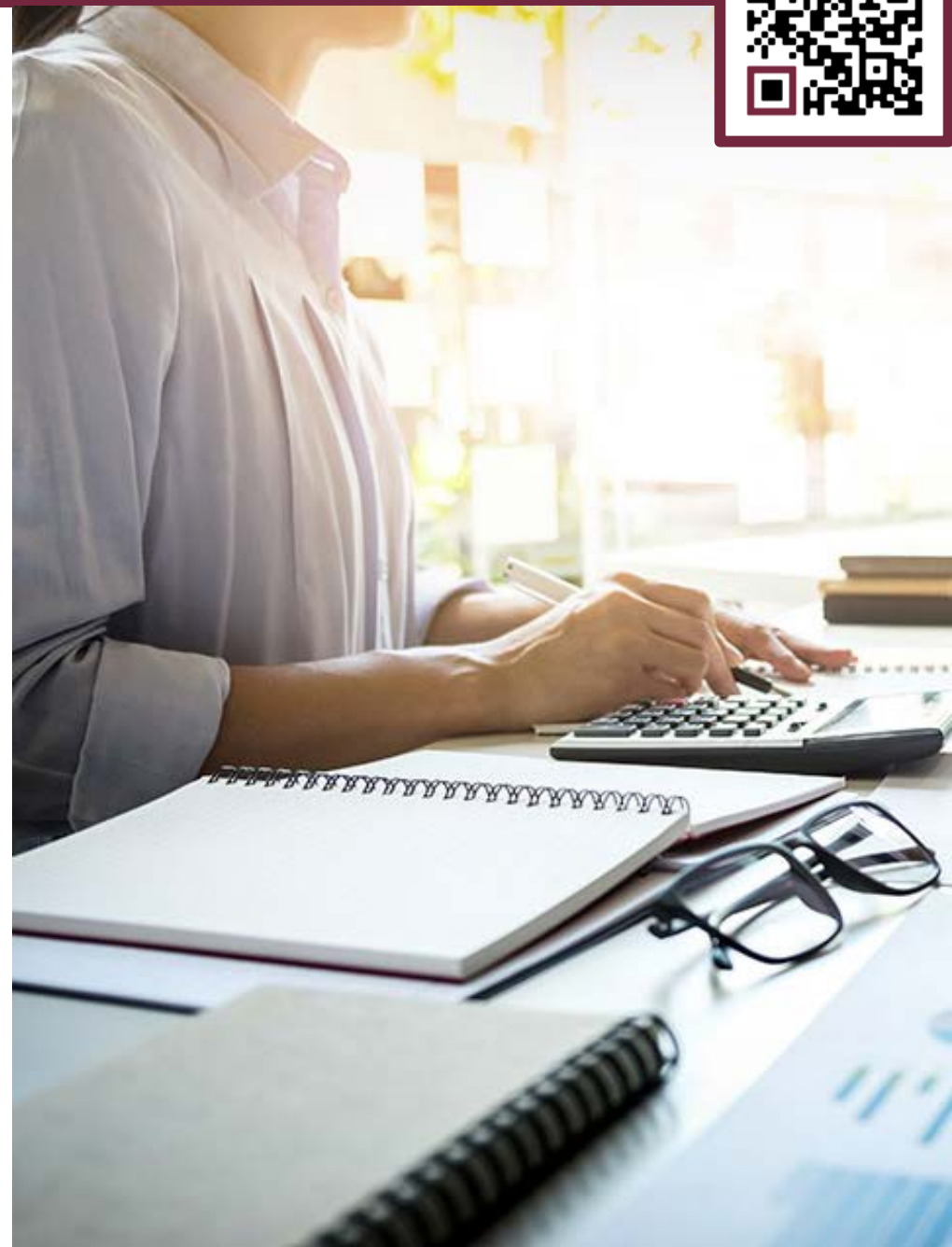


POLLING QUESTION #2



IRS INITIATIVES ON THE R&D CREDIT ISSUE

- The R&D Credit issue requires significant resources within the IRS
- SBSE and LB&I both have ongoing and prior initiatives to address auditing the R&D Credit more efficiently
- The numerous projects focused on different areas to improve R&D Credit audits
 - Taxpayer awareness
 - Revenue agent training
 - Audit tools
 - Issue strategy





IRS INITIATIVES ON THE R&D CREDIT ISSUE

SBSE

- Joint initiative with LB&I to recommend strategies and issue positions for both divisions
- Dedicated analysts on R&D Credit
- SBSE issued a directive in 2016 to have all reports on the R&D Credit reviewed
- SBSE formed 3 dedicated teams to only work cases with the R&D Credit issue in 2018
 - East coast team
 - Midwest team
 - West coast team





IRS INITIATIVES ON THE R&D CREDIT ISSUE

LB&I

- LB&I R&D Credit record keeping agreement pilot
- R&D Credit claims were an LB&I tiered issue
- LB&I has had 4 studies on the R&D Credit by engineering personnel
- LB&I currently has a multidisciplinary R&D Credit team tasked to improve RC audits
- LB&I Campaigns – Research Issues announced in 2020
- LB&I practice areas – R&D Credit falls under Business Credits





IRS INITIATIVES ON THE R&D CREDIT ISSUE

Counsel

- Claims memo of 10/15/2021 affects LB&I & SBSE
 - <https://www.irs.gov/pub/irs-lafa/20214101f.pdf>
- Memo requires information for a valid claim
- Identify all R&D business components for the year
- For each business component
 - Identify all research activities performed;
 - Identify all individuals who performed each research activity
 - Identify all the information each individual sought to discover.
- Provide total QREs (wages, supplies, contracts) for the claim year.
- Deficient claims will not be paid immediately
- Transition period Taxpayers have 45 days to perfect claims
- Transition period extended until Jan. 10, 2024





AN IRS AUDIT OF THE R&D CREDIT ISSUE

Differences in LB&I vs SBSE audits

LB&I audits

- LB&I guidance on audits emphasize collaboration
 - LB&I Examination Process (LEP) - Pub 5125
 - <https://www.irs.gov/pub/irs-utl/p5125.pdf>
 - Separate audit plan and risk analysis
 - Directive on the Centralized Risking of Research Issues under IRC §§ 41 & 174
 - <https://www.irs.gov/businesses/lbi-directive-on-the-centralized-risking-of-research-issues-under-irc-sections-41-and-174>
 - Information Document Request (IDR) Directive
 - <https://www.irs.gov/businesses/large-business-and-international-directive-on-information-document-requests-enforcement-process>
- Team coordinator on larger audits
 - Possibly multiple agents and specialists
- Same audit team for multiple audit cycles
- Audit time goal is 18 - 30 months



AN IRS AUDIT OF THE R&D CREDIT ISSUE

Differences in LB&I vs SBSE audits

SBSE audits

- SBSE guidance on audits recommend collaboration
- Single revenue agent
- Recurring audits not as likely
- Risk analysis serves as audit plan
- IDRs are likely to follow ATG example
- Audit time goal is 12-18 months





AN IRS AUDIT OF THE R&D CREDIT ISSUE

LB&I & SBSE both prepare risk analysis on issues

Risk Analysis in the IRM

- IRM 4.10.3.2 (02-26-2016)
 - https://www.irs.gov/irm/part4/irm_04-010-003#idm140629990857728
 - SBSE risk analysis serves as audit plan
- Must be considered
 - Pre-audit phase of the examination
 - Midpoint of the examination (50% rule)
 - When a significant event occurs
- IRM 4.10.2.7.1.1 (02-11-2016)
 - https://www.irs.gov/irm/part4/irm_04-010-002r#idm140137847178608
 - "Substantially Correct" 80/20 concept
 - Concept is applicable throughout the audit



WHAT IS QUALIFIED RESEARCH FOR THE CREDIT?

Qualified Research Activities (QRAs)

The Four Part Test

- §174 test
- Technological in Nature
- Business Component
- Process of Experimentation
 - Substantially all = 80%
 - Shrink back





WHAT IS QUALIFIED RESEARCH FOR THE CREDIT?

Qualified Research Expenditures (QREs)

Wages

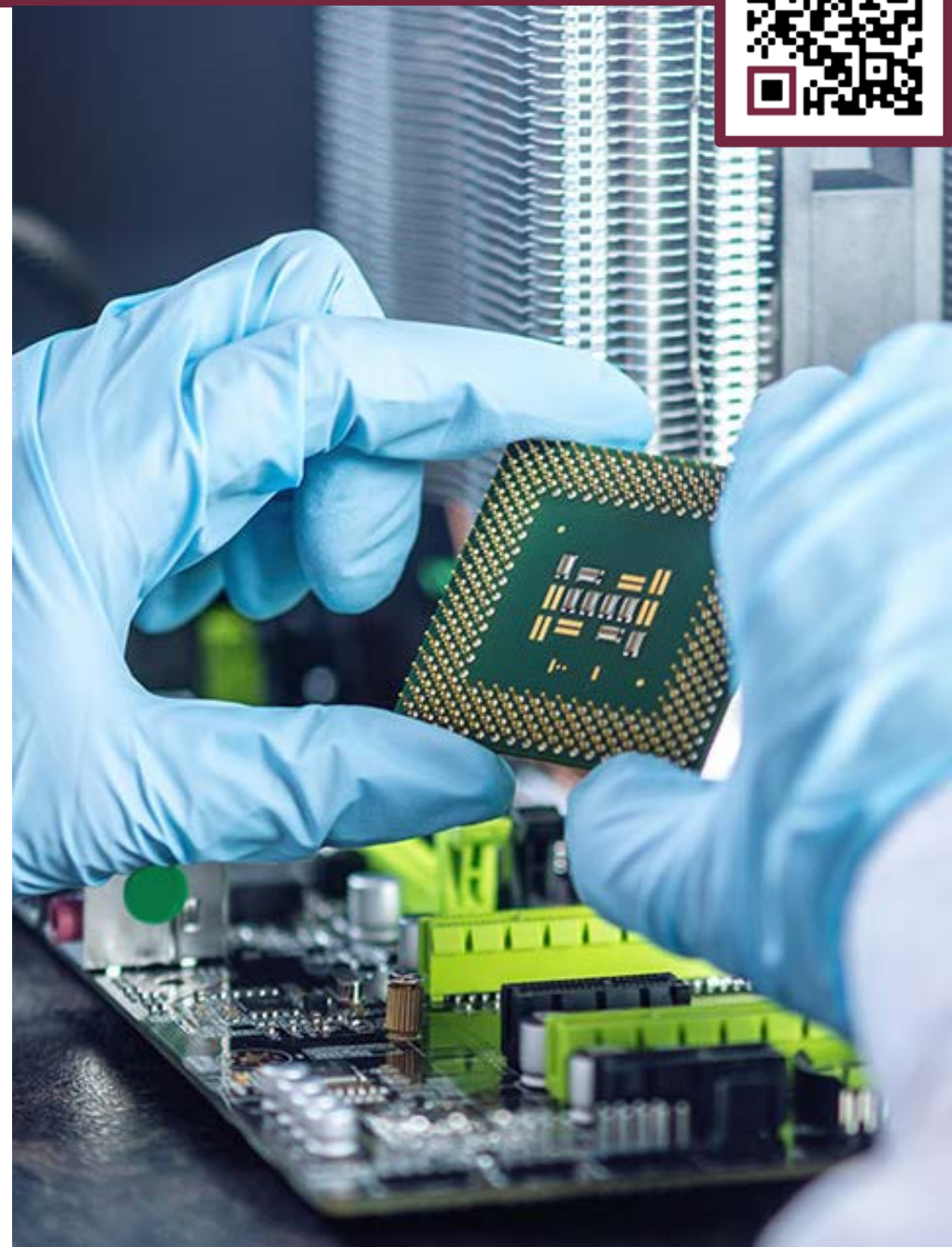
- Performing or directly supervising
- Substantially all = 80%

Supplies

- Used or consumed in the research
- Not depreciable to the entity performing R&D

Contract research

- 65% of contract expenses
- Must meet same QRA & QREs
- Retain substantial rights to research
- At risk for success of research





WHAT IS QUALIFIED RESEARCH FOR THE CREDIT?

Excluded Activities

Research after commercial production	Surveys, studies, etc.
Adaptation of existing business component	Foreign research
Duplication of existing business component	Social sciences
Internal use computer software (IUSW) *	Funded research

* IUSW can qualify if 3 additional tests are satisfied – details on slide 42



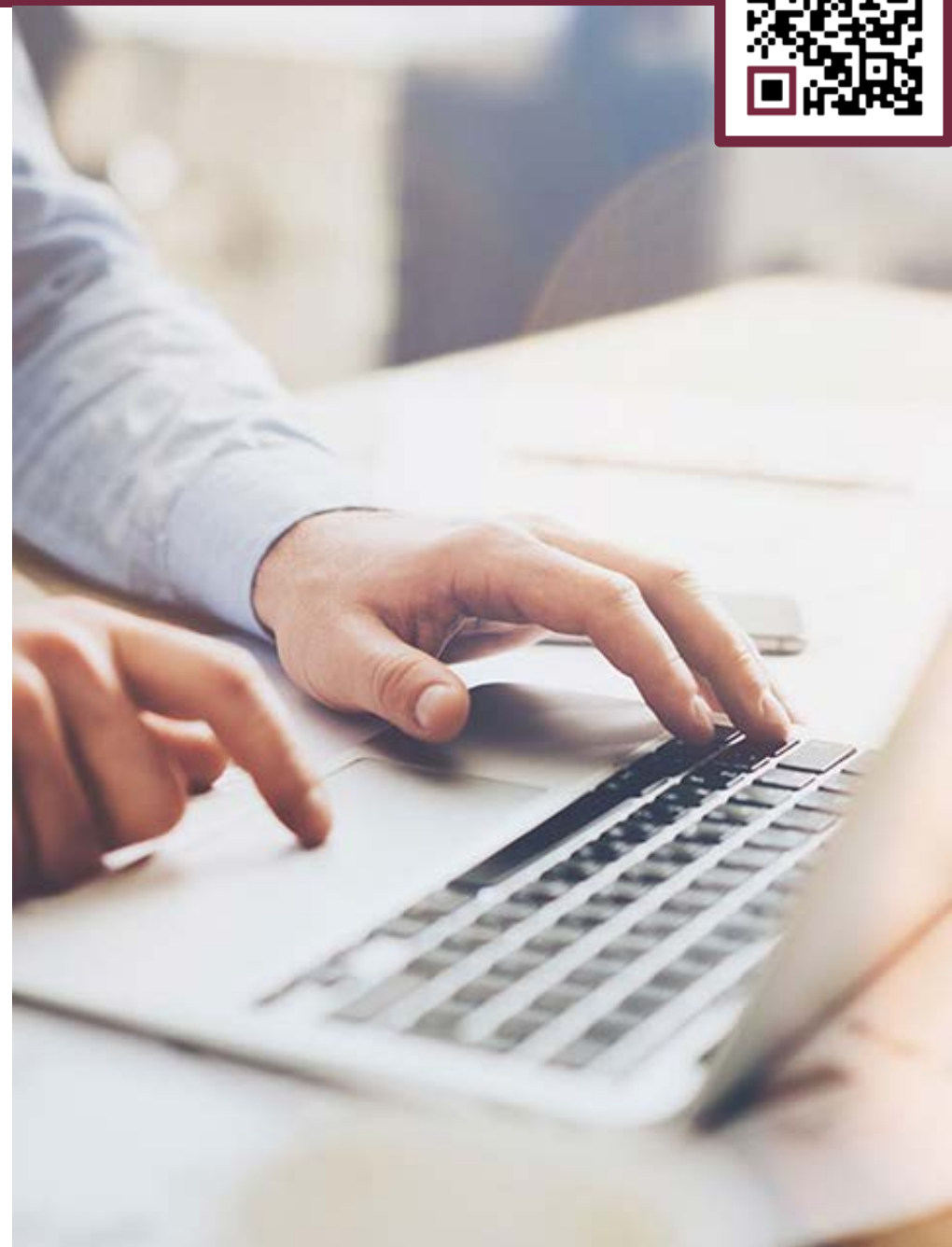
POLLING QUESTION #3



LIKELY FOCUS AREAS IN AN AUDIT OF THE R&D CREDIT ISSUE

Credit Calculations

- Traditional Method
- Alternative Simplified Credit
- Consistency with Base Period
- 280C elections
- Dispositions and Acquisitions
- Start-up companies
- Basic research





LIKELY FOCUS AREAS IN AN AUDIT OF THE R&D CREDIT ISSUE

Estimates

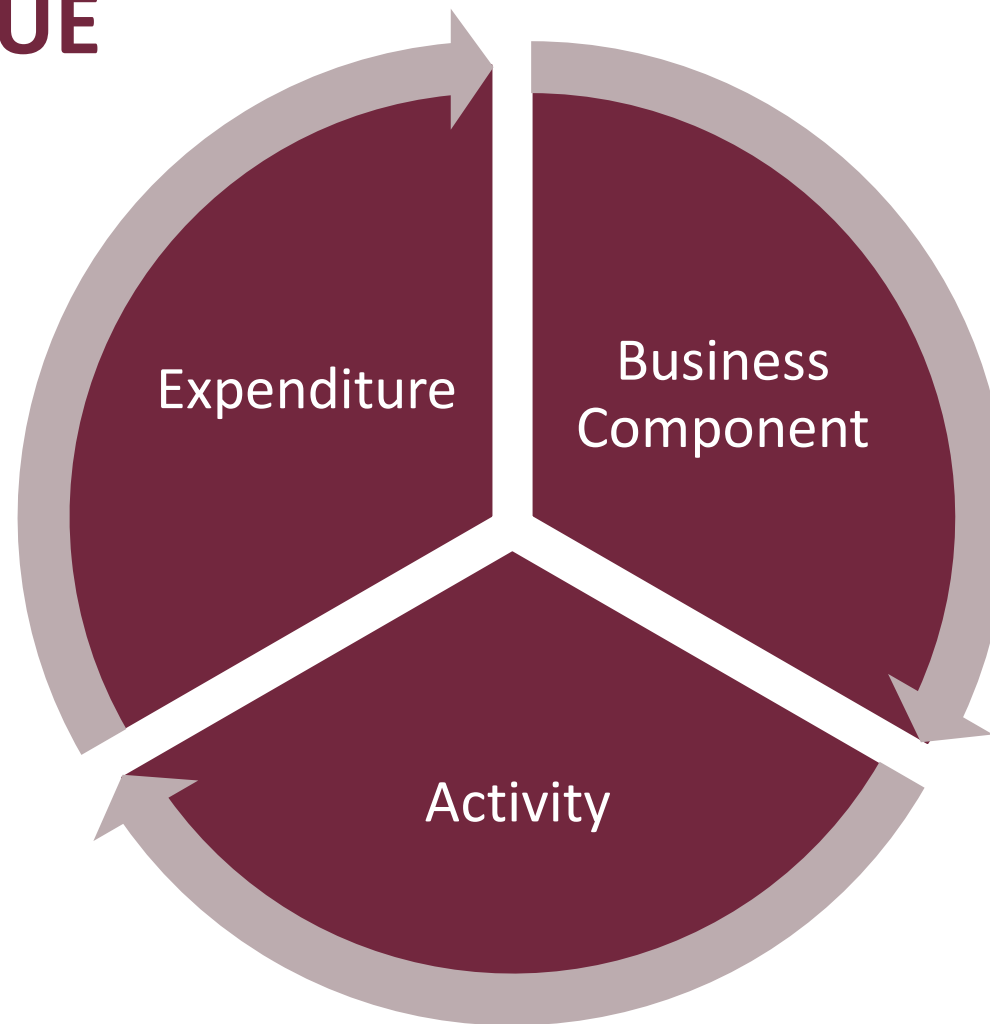
- Executives, Senior managers, department head estimating individual employee qualifying activity
- Overall Department or Cost Center estimates
- No basis or objective support
- All estimates multiples of 5 - 35%, 50%, 65%, etc.
- High estimates for senior managers
- Estimates used when project accounting data is available





LIKELY FOCUS AREAS IN AN AUDIT OF THE R&D CREDIT ISSUE

Nexus





LIKELY FOCUS AREAS IN AN AUDIT OF THE R&D CREDIT ISSUE

Statistical Samples

- Rev. Proc. 2011-42 evaluation of statistical samples and sampling estimates
 - <https://www.irs.gov/pub/irs-drop/rp-11-42.pdf>
- LB&I Field directive use of sampling methodologies in R&D Credit cases
 - https://www.irs.gov/pub/irs-utl/field_directive_samp_method_research_credit_cases.pdf
- IRM 4.47.3 Statistical Sampling Auditing Techniques
 - https://www.irs.gov/irm/part4/irm_04-047-003
- Attribute samples
- Judgement samples



LIKELY FOCUS AREAS IN AN AUDIT OF THE R&D CREDIT ISSUE

Wages

- **Job Titles and descriptions**

2nd level & Above Managers	Indirect support
Marketing	Technical Sales
Safety	Quality Control

- **Performance plans**
- **Calendars**



LIKELY FOCUS AREAS IN AN AUDIT OF THE R&D CREDIT ISSUE

Reasonable Compensation

- Suder case
- Reasonable Compensation for the position
 - C-Corp issue primarily in LB&I
 - Valuation issue – Engineering specialists
 - [Reasonable Compensation Job Aid for IRS Valuation Professionals.pdf](#)
- Reasonable Compensation for the QRAs & QREs





LIKELY FOCUS AREAS IN AN AUDIT OF THE R&D CREDIT ISSUE

Documentation/Substantiation

- Eustace case
- Contemporaneous information
 - Lab reports
 - Budget/project proposals
 - Status reports
 - Emails
- Research Credit Claims ATG
 - Pro-forma Substantiation Write-up
- SME Interview summaries





LIKELY FOCUS AREAS IN AN AUDIT OF THE R&D CREDIT ISSUE

Contract Research/Funded Research

- Who is at risk for research success?
 - Type of contract
 - Fixed fee
 - Time and Materials
- Who retains substantial rights to research results?
 - Patents
 - Copyrights
 - More than incidental benefits

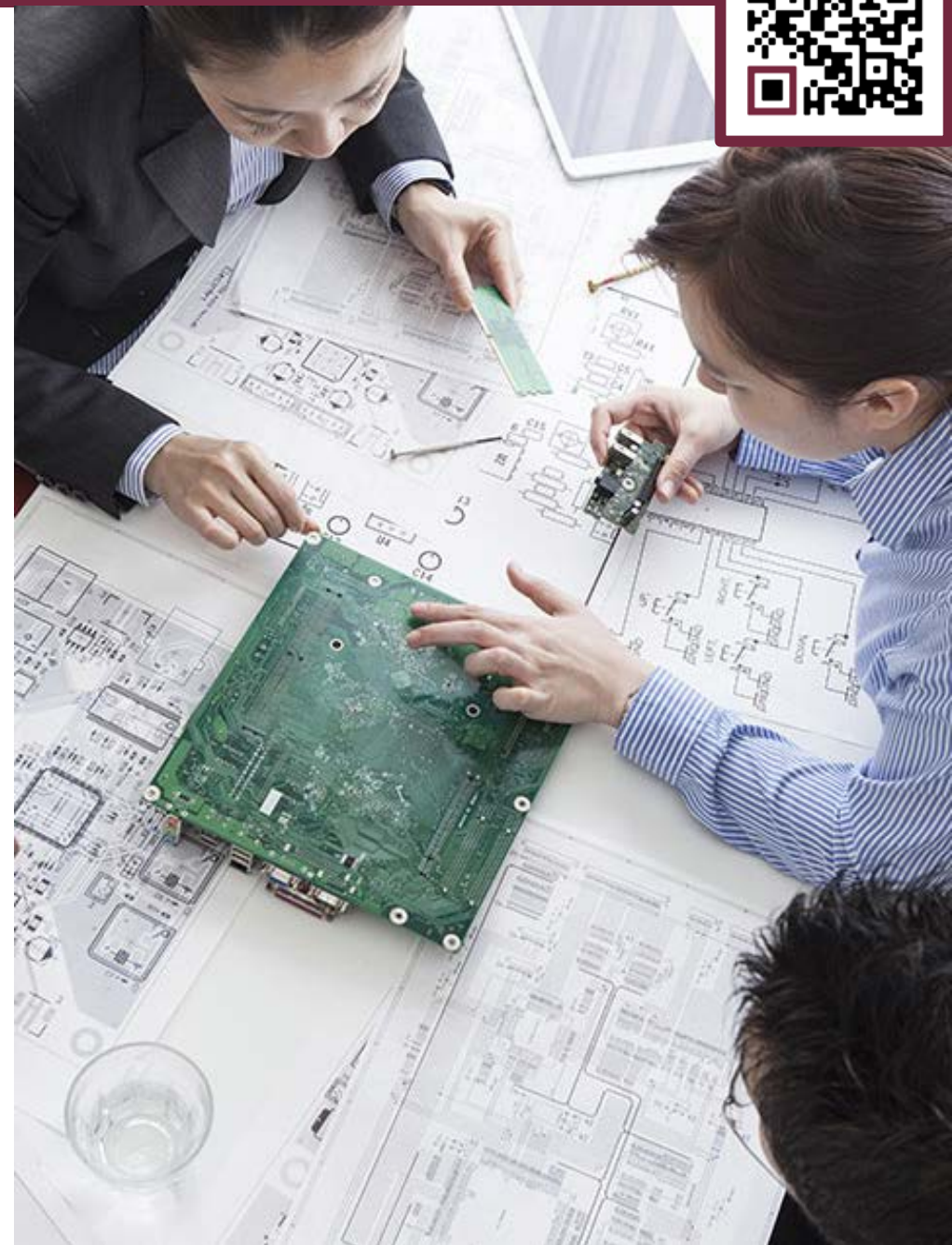




LIKELY FOCUS AREAS IN AN AUDIT OF THE R&D CREDIT ISSUE

Internal Use Software (IUSW)

- Developed primarily for internal use
- Used for general and administrative functions
- 2016 final regulations (T.D. 9786)
- 3 additional tests
 - Innovative
 - Not commercially available
 - Significant economic risk
- Not IUSW
 - Software sold, leased, or licensed
 - Software interacts with third parties
- MITRE referrals





LIKELY FOCUS AREAS IN AN AUDIT OF THE R&D CREDIT ISSUE

Semantics Matter!

Trigger Words

Better Alternatives

Likely not characterized as QRAs

Likely considered to be QRAs

Market Research

Establishing design parameters

Defining user requirements

Determining performance specifications

Brainstorming / Idea Generation

Identifying alternative design options

Status meetings/ project briefings

Critical design reviews

Trouble shooting

Process improvement

See related article at the link below for more on this topic

<https://www.accountingtoday.com/opinion/words-matter-when-describing-research-credit-activities>



POLLING QUESTION #4



AUDIT CONCLUSION

- **No Change**
- **Complete or partial disallowance**
 - Notice of Proposed Adjustments (NOPA) or 5701
 - Report explaining adjustments - 886A





R&D CREDIT ISSUE RESOLUTION

- Resolution vs Settlement
- Exam must resolve on Facts, Appeals can settle based on the hazards of litigation.
- Goal is to resolve issue at lowest level
- Meeting with manager
- Early referral to Appeals
- Fast Track
- Delegation order (DO) 4 -24
 - https://www.irs.gov/irm/part1/irm_01-002-043#idm140591633503328





APPEALS

- **Protest letter**
- **Ex Parte**
- **Cases Not Fully Developed**
- **New Information Received in Appeals**
- **Statute extension**





APPEALS

- The Appeals mission is to resolve tax controversies, without litigation
 - https://www.irs.gov/irm/part8/irm_08-006-004
- Fair and impartial resolutions
 - Mutual-Concession Settlements
 - Commonly called – Hazards of litigation
 - Nuisance Value Settlements not permitted
- Burden of Proof
- Other issue factors evaluated
 - Degree of taxpayer cooperation
 - Examiners fully support audit conclusions





ADDITIONAL IRS AUDIT RELATED PROGRAMS

- **Private Letter Rulings**
- **Pre-Filing Agreement (PFA)**
- **Technical Advice Memorandum (TAM)**
- **Industry Issue Resolutions (IIR)**
- **Compliance Assurance Process (CAP)**





TAXPAYER RIGHTS

- **IRS Publication 1**
 - Taxpayer Bill of rights
 - Some examination information
 - <https://www.irs.gov/pub/irs-pdf/p1.pdf>
- **Critical Job Elements (CJE)**
 - Fair and equitable treatment of taxpayers
- **Taxpayer Advocate**
 - <https://www.irs.gov/taxpayer-advocate>
- **Treasury Inspector General for Tax Administration (TIGTA)**
 - <https://www.treasury.gov/tigta/>

A photograph of a stone wall with a rectangular plaque. The plaque has the words "INTERNAL REVENUE SERVICE" in a serif font, arranged in three lines. The wall is made of large, light-colored stone blocks.

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