CoE Webcast Series

Cash in Your Pocket:

Navigating R&D Credits
&
Qualified Small Business Stock

LEADERSHIP • FINANCE • MARKETING • SALES • PRODUCT •
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Cash in Your Pocket:

Navigating R&D Credits and Qualified Small Business Stock

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R&D Tax Credit

R&D Tax Credits - Overview

- Research and Development Tax Credit originally enacted in 1981

- Credit –
  - Activity based
  - US based
  - Incremental over a base amount

- Historically, credits only used against income taxes

- Credits can be carried forward 20 years and carried back 1 year

- For 2016 tax years and forward, qualified small businesses can use the credits against their payroll taxes

Eligible Costs

Qualified Research Expenses (QREs) are defined under §41(b)

- **Labor**
- Supplies
- Contract Research
- Rental or lease of computers

Qualified Research

Activity must relate to:

- A new or improved product or process (business component)
- Must be technological in nature (relies on hard sciences)
- Intended to eliminate **uncertainty** concerning capability, method or design
- Engage in a **process of experimentation**

Qualified Services

Qualified Services Include:

- Engaging in qualified research; **OR**
- Engaging in direct supervision or direct support of research activities

Direct Supervision:	**Direct Support:**
• Immediate supervision such as first-line management • Research scientist who directly supervises lab experiments, but not perform experiments.	• Secretary typing reports describing lab results • Lab worker cleaning equipment used in qualified research • Clerk compiling research data • Machinist for machining a part of an experimental model used in qualified research • Does **NOT** include G&A services – payroll processing for scientists

Excluded Activities

Section 41(d)(4) Lists Specific Exclusions

- Research after Commercial Production
- Adaptation of Existing Business Components
- Duplication of Existing Business Components
- Surveys, studies
- Foreign Research
- Social Sciences (arts; humanities)
- Funded Research

Simplified vs. Regular Method

Simplified Method	Regular Method
• Section B of Form 6765	• Section A of Form 6765
• Base amount equals 50% of average QRE over prior 3 tax years.	• Lesser of incremental or 50% of current year QRE applied to a 20% credit rate.
• Incremental QRE applied to a 14% credit rate.	• Base amount = Fixed base percentage * Prior 4 years average annual gross receipts.
• No QRE in any of prior 3 tax years, must take 6% credit rate against current year QRE.	• Fixed base percentage – Start-Up companies – 3% for first 5 years; then a statutorily based percentage of QRE / Gross Receipts for specific years (§41(c)(3)(B)(iii).
• Both credits are incremental over a base amount	

The Calculation

- 280C Elections reduces each credit by 21% = “Net Credit”
- Generally, the ROI on QRE would be:
  - Regular Method – 7.9% of QRE
  - Simplified (with QRE in 3 prior tax years) - Approximately 6% of QRE
  - Simplified (without QRE in 3 prior tax years) – 4.7% of QRE
- **Important Note** – The method selected on the originally filed return CANNOT be changed

Payroll Tax Credit

- FICA Refund from an R&D Tax Credit
- **Eligibility** –
  - Claim an R&D Tax Credit within deadline (extensions included)
  - Less than $5M in gross receipts in current tax filing
  - Zero gross receipts prior to 5 tax years from the tax filing
  - Use of PEOs does not disqualify taxpayer
- Gross Receipts – **Any receipt including interest** or a de minimis amount.

Payroll Tax Credit - Eligibility

Zero gross receipts prior to 5 tax years from the tax filing

Tax Year	Year
2018 (Current Filing)	1 <$5M in receipts allowed.
2017	2
2016	3
2015	4
2014	5
2013	No receipts allowed.

Payroll / FICA Refund (Example 1)

Company incorporated in October of 2014

Tax Year	Gross Receipts	Year
2018 (Current Filing)	$400,000 (sales)	1
2017	$100 (interest)	2
2016	$100 (interest)	3
2015	$100 (interest)	4
2014	$50 (interest)	5

Qualified Eligible Small Business

Payroll / FICA Refund (Example 2)

Company incorporated in October of 2014.

Tax Year	Gross Receipts	Year
2018 (Current Filing)	$400,000 (sales)	1
2017	$10,000,000 (grants)	2
2016	$100 (interest)	3
2015	$100 (interest)	4
2014	$50 (interest)	5

Qualified Eligible Small Business.

Can have >$5M in gross receipts within the 5 year window.

Payroll / FICA Refund (Example 3)

Company incorporated in October of 2014.

Tax Year	Gross Receipts	Year
2018 (Current Filing)	$400,000 (sales)	1
2017	$100 (interest)	2
12/31/2016	$100 (interest)	3
6/31/2016	$100 (interest)	4
2015	$50 (interest)	5
2014	$50 (interest)	6

<u>Not a Qualified Eligible Small Business</u>.

A short tax year counts as a "year" for the 5 year window.

FICA Refund Election

- Form 6765 – Claim an R&D credit

- Form 6765 - Box in Line 41 of Section D **must be checked**.
  - No relief granted if Box not checked.
  - Cannot amend to be eligible.

- Elect amount to be used (not more than 250K) on Line 42

- If claiming payroll credit, should consider taking the Gross Credit and check "No" on the 280C.
  - Result will increase credit for payroll usage, but reduce deductions by amount of Gross Credit.

FICA Refund Election con’t

- Instructions have been created.
  - After filing, be sure to send to client.
- File Form 8974 with Form 941 in the subsequent quarter after the taxpayer’s tax filing
- Taxpayer can use credits up to 50% of amounts due from Lines 5a and 5b from Form 941.
- Credits can be used against ALL employee’s payroll tax liability, not just R&D employees.
- Current 10/15 filers will **file Form 8974** on Q1 2020 Form 941 filings.

TIGTA IRS Exam Procedures

- Treasury Inspector General for Tax Administration (TIGTA)

- Report issued in late December

- Results of Review –
  - IRS did not have processes to identify –
    - If eligibility requirements were met;
    - If claimed payroll offset too early;
    - If claimed too much credit.

- Action Plan –
  - IRS drafted compliance plan for how credit offset will be classified and selected for exam
  - Implied increased likelihood of exam

IRS Exam Substantiation

- Methodology Memorandum
- Business Components
- Documentation
- Cost Schedules

Contact Information

For more information on R&D Credits:

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Qualified Small Business Stock
§ 1202

Qualified Small Business Stock - Defined

What's the purpose?

- Designed to stimulate investment in certain SMEs
- Allows exclusion or deferral of some or all gains from the disposition of QSBS

Amount of Exclusion

§ 1202 Stock Acquired	Capital Gain Exclusion	AMT addback	Tax rate on gain not excluded
8/11/93 - 2/17/09	50%	7%	28%
2/18/09 - 9/27/10	75%	7%	28%
9/28/10 - Present	100%	0%	n/a

QSBS - Requirements

1. Issued by a domestic corporation with < $50 million in assets at time of and immediately after issuance

2. Issued by a corporation that uses at least 80% of its assets in active trade or business (other than personal services)

3. Held by a Non Corporate taxpayer (LLCs & S Corps qualify)

4. Acquired by taxpayer on original issuance, and

5. Held for more than 5 years

6. Gain Eligible for Exclusion
   - Limited to greater of $10 million or 10 times the taxpayers' basis in the QSBS

QSBS – Requirements (continued)

- QSBS does <u>not</u> apply to equity interests in pass-through entities, such as S-corps or partnerships.
  - <u>Only</u> C corp stock

- QSBS held by a pass-through entity
  - May potentially qualify as gain eligible for the §1202 exclusion.

  - Must have held the interest on the date the pass-through entity acquired the QSBS

  - Must have held the interest all times thereafter until the stock was sold.

QSBS – Original Issue Requirement

QSBS must generally be acquired at "original issue" (directly or through an underwriter)

- In exchange for money or other property,

or

- As compensation for services performed for such corporation.

QSBS – Holding Period

- Acquisition date for stock based compensation:
    - Incentive Stock Options - Date of exercise
    - Restricted Stock - no §83(b) election - Date of vesting
    - Restricted Stock §83(b) election - Date of election

- Stock Options:
  - Do <u>not</u> qualify as QSBS (until exercised)
  - Recipient is considered to own the stock when they have an unrestricted right to the shares

QSBS – Section 1045 Roll-over

§1045 permits taxpayers other than a corporation to defer gain on a sale of QSBS if it held the stock > 6 months

- Election is made on the tax return.
- Must purchase new QSBS within 60 days of sale
- If reinvestment in QSBS is less than sale proceeds, difference is taxable at regular rates
- No limit on how much can be rolled over
- Replacement stock can be more than one company or a portfolio of small businesses.

QSBS – States of Adoption § 1202

- New Jersey – Pending
- Pennsylvania – No
- New York – Yes

Best Practices

The taxpayer should maintain a file documenting the following as of the date of each share issuance (or quarterly at a minimum):

- Balance sheets: Show total assets and percent of assets used in active trade or business
- Proof of C Corporation status (i.e. articles of incorporation, copies of 1120 tax returns)
- Affidavit signed by an officer that the Company does not fall under the categories of the disqualified trade or businesses AND that it is not one of the types of ineligible corporations

Example #1 - $10M Gain Exclusion

- On 7/1/2008, John invested 40 cents to buy 200K shares of ABC Corp. (QSBS) (50% exclusion)
- On 7/1/2015 (7 yrs. later), John sold all 200K shares for $22M.
- John realized $22M Long Term Capital Gain (LTCG).
- John qualified for the $10M QSBS gain exclusion.
- Thus, John, on his 2015 individual return, can exclude $5 million of the gain, i.e., 50% × the $10 million cap, not 50% of $22 million.

Example #2 - 10X Basis Gain Exclusion

- On 7/1/2008, Jane invested $3M to buy 200K shares of ABC Corp. (QSBS) (50% exclusion)

- On 7/1/2015 (7 yrs. later), Jane sold all 200K shares for $60M.

- Jane realized $57M LTCG.

- Jane qualified for a $30M (10X Basis) QSBS gain exclusion.

- Thus, Jane, on her 2015 individual return, can exclude $15 million of the gain, i.e., 50% × the 30 million cap.

Example #3 - §1045 Gain Roll Over

- Charlie invests $400,000 in Eagle Corp., a manufacturing company, on 8/26/14. Eagle stock qualifies as QSBS for 100% exclusion.

- On 10/6/15, Charlie sells the Eagle stock for $625,000, resulting in a $225,000 gain.

- On 10/20/15, he purchases stock in newly formed Hawk Corp. for $600,000. Hawk stock also qualifies as QSBS.

- Charlie elects to roll over the gain from the sale of the Eagle stock.

Example #3 - Continued

- Charlie recognizes only $25,000 of the gain because this is the amount the sales proceeds ($625,000) exceed his investment in Hawk ($600,000).
- Charlie's basis in his Hawk stock is $400,000 ($600,000 cost less deferred gain of $200,000).
- The holding period in Eagle stock is added to the holding period of the Hawk stock for all purposes except for determining whether Hawk meets the active business requirement for the six-month period following purchase.

Contact Information

For more information on Qualified Small Business Stock:

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Upcoming Webcasts

Sales & Marketing CoE Webcast: Account-based Marketing (ABM)

Thursday, September 12th at 2:00 p.m.

Alex Symos
VP, Go-To-Market Center of Excellence
edisonpartners

Torrey Dye
Director of ABM and Demand Generation
terminus

Finance CoE Webcast: Combating Unconscious Bias - Creating an Inclusive & Upstander Culture

Thursday, October 24th at 2:00 p.m.

Eileen Covey
Director of Finance & Operations
edisonpartners

Katherin Nukk-Freeman, Esq
Co-Founder, SHIFT HR Compliance Training
SHIFT HR COMPLIANCE TRAINING

THANK YOU

for joining us