Taxing Innovation

How Changes in the Sec. 174 R&D Tax Deduction Threaten America's Startups

July 13, 2023

SBTC Small Business Technology Council

CLEAN ENERGY BUSINESS NETWORK

CLEAN ENERGY BUSINESS NETWORK®

the small business voice for the clean energy economy

Policy Support

Market & Technology Education

Business Development Assistance

Small Business Technology Council

Non-partisan, non-profit industry association of companies dedicated to promoting the creation and growth of research-intensive, technology-based U.S. small business.

- Education
- Voice in Washington
- Exchange of ideas, including CEO forum
- Advancing the Small Business Innovation Research (SBIR) program

Agenda

Overview

- Changes to Sec. 174 R&D Deduction
- Legislative Fixes
- Possible Alternative: Sec. 162
- Take Action

Expert Speakers

- Clancy Lyles, Legislative Aide, Sen. Todd Young (R-IN)
- Jere Glover, Executive Director, Small Business Technology Council

Group Discussion

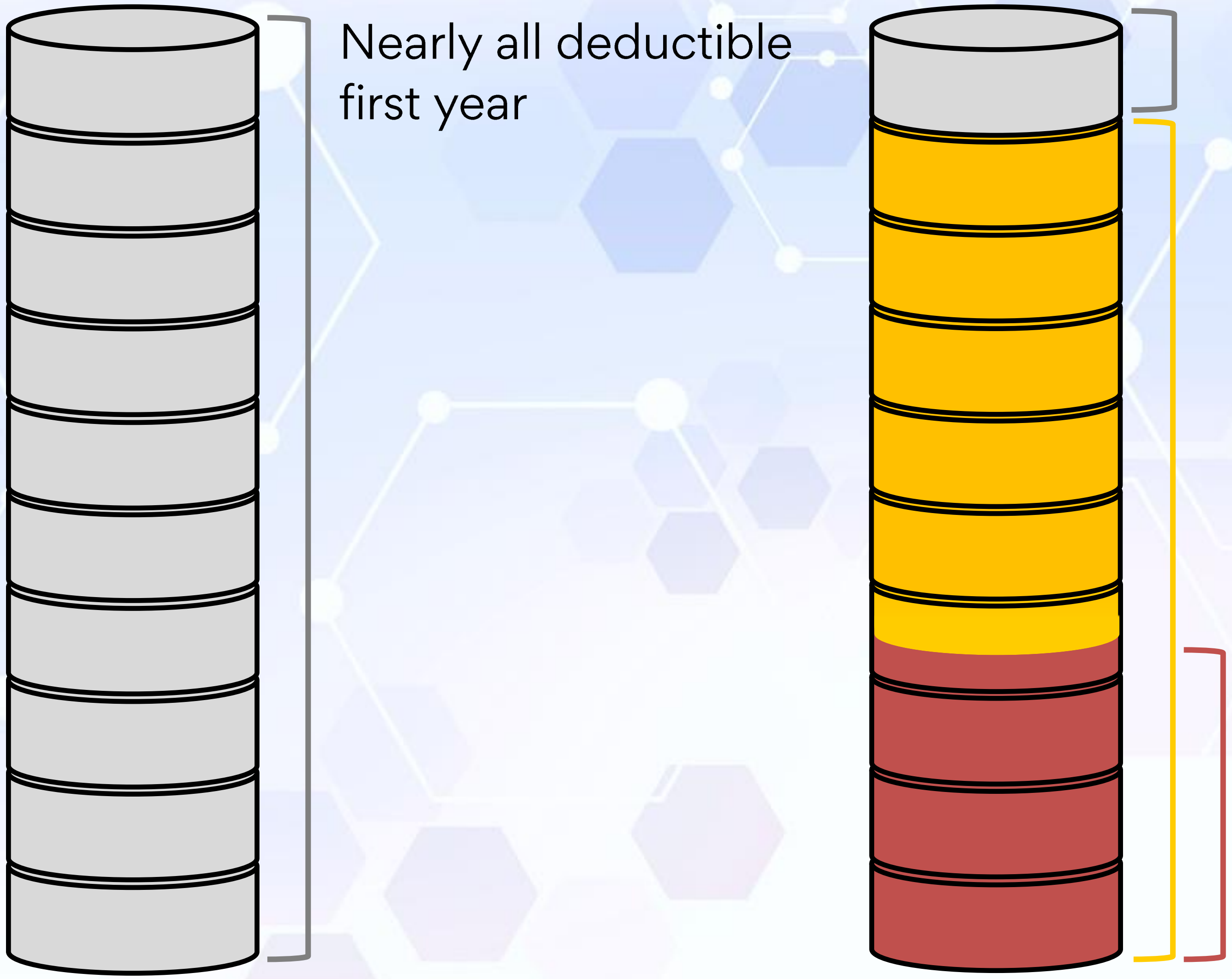
Sec. 174 R&D Deduction

- Since 1954, R&D expenses qualified for immediate expensing under the Sec. 174 federal tax deduction.
- As of 2022, must now be amortized over 5 years, with 10% cap in first year.

Case Study

$2M SBIR Phase II award

(as assessed by the recipient's accountant
based on the firm's taxable rate)



BEFORE 2022:

Nearly all deductible first year

AS OF 2022:

10% deductible first year

$1.8M net income

$700K tax liability

Alternatives

Some firms are deducting R&D expenses under Sec. 162.

- Deduction for all **ordinary and necessary expenses** paid or incurred during the taxable year in **carrying on** any trade or business

But confusion and controversy abound!

- Do startups meet the “carrying on” standard?
- Can SBIR awardees argue that the work they are performing is a fee for service under contract?
- Does the type of award (cost reimbursable vs. fixed price) matter?

Talk to an accountant experienced with your type of business and situation!

Sources: SBTC, Jameson & Company, Bloomberg

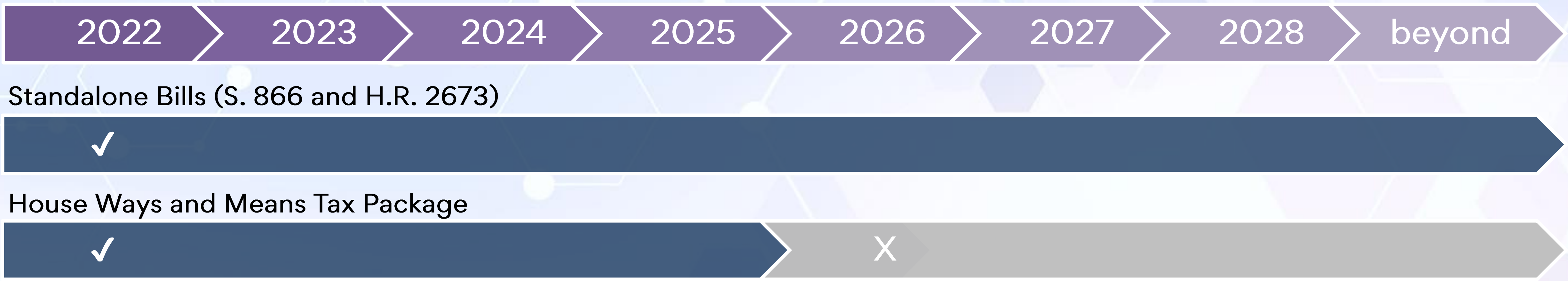
Legislation

Bicameral, bipartisan legislation to restore immediate expensing of Sec. 174:

- S. 866 (American Innovation and Jobs Act):
  Sens. Hassan (D-NH) and Young (R-IN) with 34 other bipartisan co-sponsors
- H.R. 2673 (American Innovation and R&D Competitiveness Act):
  Reps. Estes (R-KS-4) and Larson (D-CT-01) with 130 other bipartisan co-sponsors

House Ways & Means Tax Package (Build it in America Act):

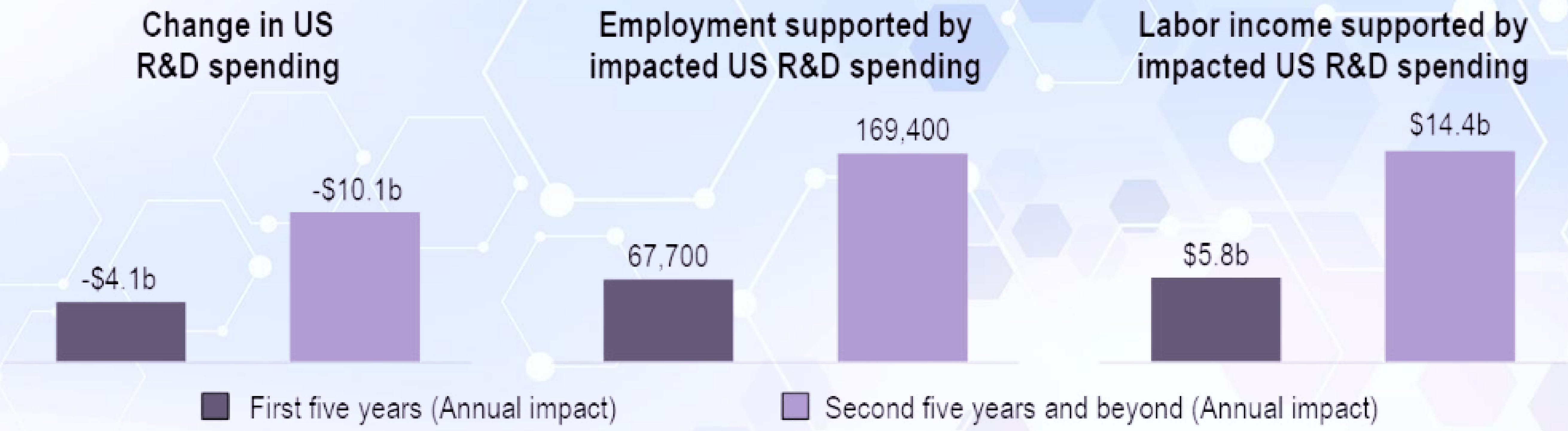
- Restores immediate expensing from 2022-2025 but at cost of repealing several energy tax credits



Economic Impacts

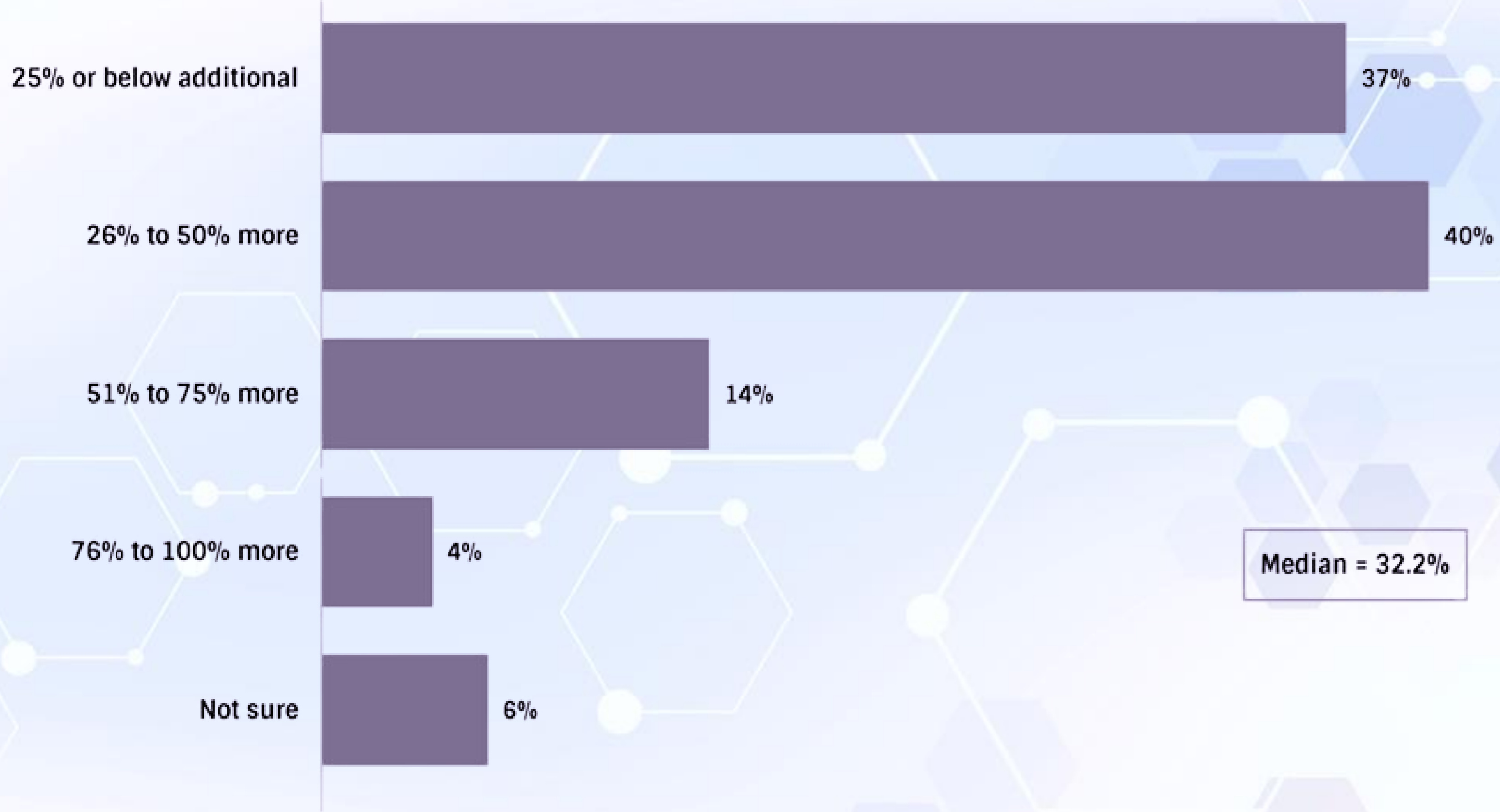
Ernst & Young:

- More than $4B in reduced R&D and 67k lost jobs per year in first 5 years.



Small Business & Entrepreneurship Council survey (n=461):

- 29% of small businesses (45% in tech) use immediate expensing of Sec. 174.
- Their tax bill will increase by a median of 32%, or $59k.

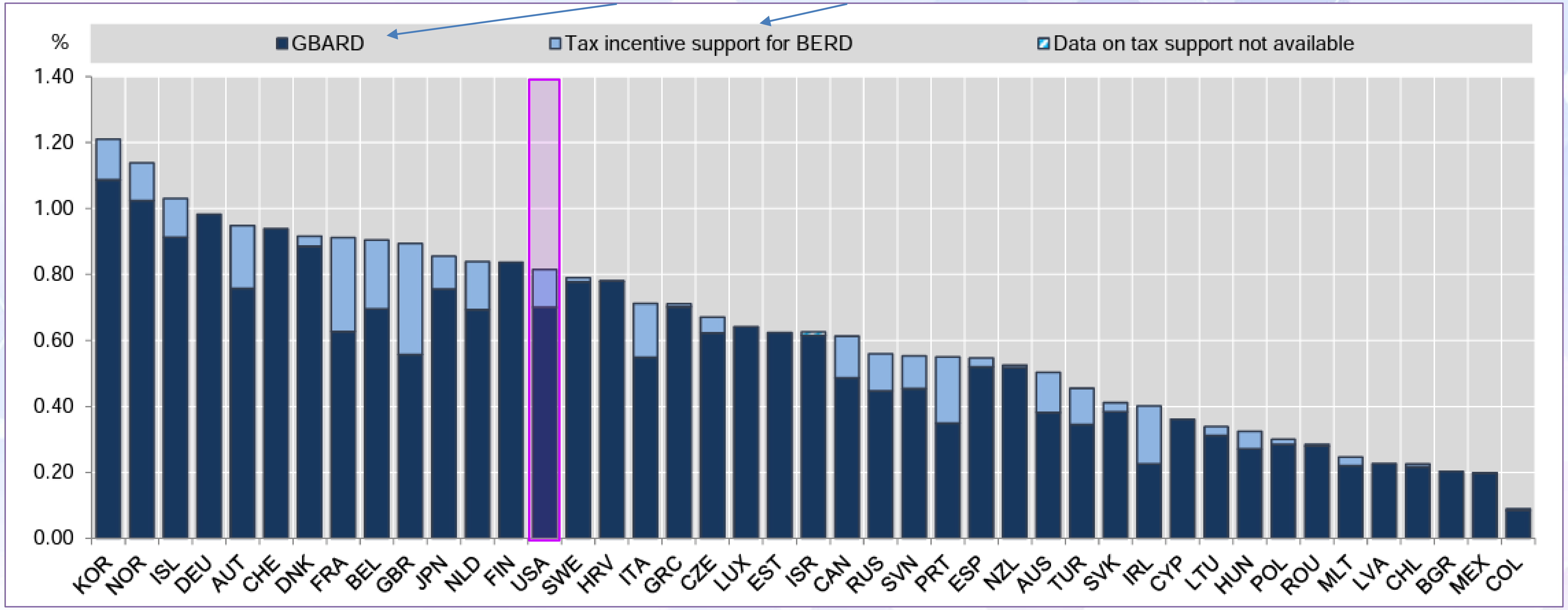


Q15. If the R&D tax credit is not extended or made permanent for 2023, what is your business's approximate "tax hit"? How much will your tax bill go up?, Base: 150 businesses that used R&D tax credit+/-8.2 PTS

OECD R&D Rankings:

- U.S. one of just two developed countries with amortization of R&D deduction.
- This comes on top of an already marginal landscape for U.S. tax support for R&D.

Government tax relief and incentives for business R&D



Small Business Stories

Quotes from CEBN members:

"It WILL bankrupt us if nothing is done. No two ways about it."

*small business in **Arizona***

"Amortizing the R&D expenditure is a kiss of death for us… Do we need to say more?"

*small business in **Washington***

"Our taxes have almost doubled due to this. We will likely no longer be able to operate if this continues."

*small business in **Florida***

Take Action

Learn:

- Sec. 174 Resource Center

Take Action:

- Sign-on letter to Congress
- Impact survey (included as optional question in the letter form)
- Email message to your elected officials (follows the letter)
- Contact us if interested in meeting with your elected officials

Spread the Word:

- Share our Resource Center and letter with others

Clancy Lyles

Legislative Aide
Senator Todd Young (R-IN)

Jere Glover

Executive Director
Small Business Technology Council

Sycamore Growth Group

- **Advisory Firm: R&D Tax Credits**
  - Founded: 2011
  - 20 Employees
- **Point of Differentiation to Other Specialty R&D Firms**
  - Industrial Strength Substantiation
    - Writing = Safety
    - Never had a certification rejected under audit

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General Discussion

- Section 162 relates to expenses incurred in “carrying on” a “trade or business”
  - Ordinary and Necessary expenses
- Section 174 relates to expenses incurred in “connection with” a “trade or business”
  - Research and Experimentation expenses
  - Allowed businesses to deduct expenses prior to actual commencement of a trade or business
- A “trade or business” is defined in the same way for both sections:
  - “with the primary purpose of making a profit”
- The primary difference has been held to be that Section 174 can be utilized to deduct expenses <u>prior</u> to the actual commencement of a trade or business.
  - “Start up” costs
- Section 41 permits the use of Section 174 expenses to be claimed as research and development credits
  - When certain conditions are met
- Section 41 is widely used by companies that are not start ups
  - This is why many accountants (incorrectly) seem to believe that all research and experimentation expenses fall under Section 174
- Ordinary and Necessary expenses <u>can</u> include Research and Experimentation expenses
  - – Fact specific and will vary based on actual circumstances

What is Accounting Industry's Position on 174?

Assumption: 174 Controls the Treatment for ALL expenses that meet the broad definition of Research & Experimentation (R&E)

Why Do They Think That?

- 174 applies to R&E *expenditures* *"in connection with"* the business
- 162 applies *expenses* to *"carrying on"* the business

Key Error: Industry wrongly thinks that 174 is a broader standard and thus must control ALL R&E cost treatment. Actually, 174 is the Lesser Standard.

Dogs vs Wolves

174 Election: Who <u>Has</u> to Use 174?

1) Start Ups (Pre Revenue)

1) Internal (self-funded) R&D that is for *pursuing* a business, NOT *carrying on* a business.

*Understand the nature of your activities and the stage of business to which they relate!

Section 174 vs. Section 162

Case Law Considerations

Kenan Ezal

18 May 2023

Legal Authorities

- *Section 162 vs.174:*
  - *Snow v. Commissioner of Internal Revenue*, 416 U.S. 500 (1974)
  - *Kantor v. Commissioner of Internal Revenue*, 998 F.2d 1514 (1993)
  - *Scoggins v. Commissioner of Internal Revenue*, 46 F.3d 950 (1995)
  - *Office of Chief Counsel, Internal Revenue Service, Memorandum*, Number 20055203F, December 20, 2005
    - This memorandum contains a very good summary of case law and differences between Section 162 and Section 174
- Section 162: Defining Ordinary and Necessary Expenses
  - *Commissioner v. Lincoln Savings and Loan Association*, 403 U.S. 345, 352 (1971)
  - *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966)
- Case law involves a Section 174 deduction that is challenged by the IRS
  - Have not discovered case law where a Section 162 expense is challenged and found to be a Section 174 expense

Snow v. Commissioner of Internal Revenue
416 U.S. 500 (1974)

- The Supreme Court permitted a Section 174 deduction for a taxpayer that had yet to establish an ongoing business
- Section 174 permits a deduction for expenses incurred “in connection with” a trade or business, but where those expenses would not have qualified under Section 162
  - Section 162 requires an ongoing trade or business (“carrying on”)

Scoggins v. Commissioner of Internal Revenue
46 F.3d 950 (1995)

“The idea behind section 174 is to encourage research and experimentation by small, new enterprises and to place them on an equal footing with established businesses, which may deduct under section 162(a) the expenses incurred while carrying on a trade or business.

Consequently, taxpayers whose only "business" at the time they incur the research expenditures is the research itself are eligible for the expense deduction under section 174. *Kantor*, 998 F.2d at 1518.

Thus, while new businesses must capitalize their "start-up" or "preoperational" expenses because they are not deductible under section 162, section 174 alters this requirement by permitting new, pioneering businesses, which are not yet selling goods or services, to deduct immediately expenditures incurred for research and experimentation.”

- [*Scoggins* at p. 954]

IRS Memorandum, Number 20055203F
December 20, 2005

“The courts have held that the section 174 “in connection with” language allows a taxpayer to deduct R&E expenses prior to the actual commencement of a trade or business, while under section 162 a taxpayer must be “carrying on”, or already engaged in, a trade or business.”

Summary

- Case law that differentiates between Section 162 and Section 174 has not been overturned
  - Section 162 is available to an entity that is carrying on an established business activity for profit
  - Section 174 is available to an entity that is conducting research and experimentation in connection with a business that has not yet been established
- What if an established business incurs research and experimentation expenses?
  - Are those expenses incurred under contracted research?
    - May be Section 162 expenses
  - Are those expenses incurred using own funds?
    - May be Section 174 expenses
- Section 162 does <u>not</u> require “ownership” of research activity results
  - Nor does it require that another entity owns the resulting research
- Ownership and usage of intellectual property and data rights associated with research expenses are irrelevant under Section 162
  - Are the expenses ordinary and necessary in carrying on a business?

Group Discussion

- What are you experiencing?
- What are you hearing from your accountant?
- Have you tried any solutions (e.g., Sec. 162)?
- Any indication if they may be successful?
- How applicable is your situation to others?
- Any other questions for your peers?