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Research Credits Offer Increased Opportunities for Tax Savings Post Tax Reform

The Tax Cuts and Jobs Act (TCJA) included significant changes to the taxation of individuals, businesses, and multinational entities.

In exchange for reduced rates, many deductions and credits were eliminated or are now subject to substantial limitations. In one notable exception, the TCJA preserved the federal credit for increasing research activities (research credit), including the ability for qualified small businesses to designate up to $250,000 of the research credit as an offset to payroll tax as well as the ability for eligible small businesses to use the research credit against alternative minimum tax (AMT) liability (which was repealed for corporate taxpayers). Discussed below is the impact the TCJA has on some popular tax deductions and insight on how research credits may be an even more valuable tool for taxpayers to manage their tax position post tax reform.

Impact of Tax Reform on Deductions

Despite reduced tax rates, the loss or limitation of certain deductions may have an overall negative effect on a taxpayer's position. Under the TCJA, the Sec. 199 domestic production activity deduction was eliminated. There are also new limits on deductions for business related entertainment and meal and beverage expenses. In addition, the

TCJA imposes a broad new limitation on business interest deductions and limits the use of net operating loss (NOL) carryforwards to offset taxable income in subsequent tax years.

The new law limits the amount of NOL carryforward that can be utilized to 80% of taxable income, effective for losses arising in tax years beginning after December 31, 2017. The ability to carryback NOLs to prior tax years was rescinded for losses arising in tax years ending after December 31, 2017 (i.e., no carrybacks permitted), but the 20-year expiration of NOLs was also eliminated, meaning NOLs arising in tax years ending after December 31, 2017 can be carried forward indefinitely. Without the ability to use all NOL carryforwards due to the new 80% limitation, companies may have to pay tax on a minimum of 20% of their taxable income. Research credits present an opportunity for these taxpayers to mitigate the new loss limitations and reduce taxes paid on the income that cannot be offset by NOL carryforwards.

Reduction in Corporate Tax Rate

The TCJA reduced the maximum corporate tax rate from 35% to a flat 21%. Taxpayers are generally required to reduce their research and experimentation (R&E) deduction by the amount of research credit claimed, unless they make a Sec. 280C reduced credit election which allows them to retain the full R&E deduction. The Sec. 280C reduction to the research credit is equal to this new 21% maximum corporate tax rate.

Pass-through business owners will see a greater benefit from making the Sec. 280C election post tax reform. The TCJA increased the spread between the corporate tax rate and the highest marginal individual tax rate (a 35% corporate rate compared to a 39.6% individual rate under pre-tax reform rates, versus a 21% corporate rate compared to a 37% individual rate under the TCJA). Therefore, the benefit of making the reduced credit election is enhanced for individual taxpayers. For every $100 of research credit, an individual taxpayer gives up $21 of credit to avoid paying an additional $37 of tax (a net federal benefit of $16). Prior to the TCJA, the same individual had to give up $35 of credit to avoid paying an additional $39.60 in tax (a net federal benefit of $4.60).

There are however some situations where forgoing the Sec. 280C reduced credit election is advisable, even under the new rate structure. Early-stage companies with losses should forgo the reduced credit election if the reduction to their credit reduces the amount available to offset payroll tax to an amount under $250,000. It is expected that the cash value of the payroll credit will be more valuable than preserving the full value of the R&E deduction, which will be embedded in an NOL carryforward as a deferred tax asset.

Alternative Minimum Tax

The TCJA repeals the corporate AMT for tax years beginning after December 31, 2017. The Protecting Americans from Tax Hikes (PATH) Act of 2016 designated the research credit as a specified credit for eligible small businesses to offset AMT. Eligible small businesses are businesses with less than $50 million in average gross receipts in the prior three tax years (defined in Sec. 38(c)(5)). With the repeal of the AMT, businesses now subject to regular tax can use research credits to offset a portion of their regular tax liability. Under Sec. 38(c), the research credit is limited to offsetting up to 25% of the amount of regular tax that exceeds $25,000. Individuals can still benefit from the pass-through of research credits from eligible small businesses to offset AMT liability arising from the same trade or business.

Section 174 Deduction for R&E Expenses

Under prior law taxpayers could elect a method of accounting for R&E expenses that allowed them to currently deduct the expenses in the year they were incurred, or to amortize them over a period of no less than 60 months. Under the TCJA changes, specified R&E expenses under Sec. 174, including software development expenditures that are paid or incurred in tax years beginning after December 31, 2021, must be capitalized and amortized over a five-year period for research conducted in the U.S. Specified R&E expenses that are attributable to research conducted outside the U.S. must be capitalized and amortized ratably over a 15-year period.

The pending elimination of the current deduction for R&E expenses provides strong incentives for companies to undertake capital development projects that require significant research and development before 2022 so that they can maximize the value of the related R&E deductions. The longer capitalization period for foreign research beginning in 2022 creates additional incentive to locate development efforts in the U.S.

Choice of Entity and M&A Planning

Some taxpayers are evaluating choice of entity options after the TCJA's rate reductions and other new provisions. Taxpayers should be sure to consider research credit utilization in the context of any change in entity structure. Those taxpayers considering a switch to an S corporation from a C corporation should be aware that research credit carryforwards that passed through to shareholders may be suspended indefinitely at the shareholder level if the S corporation will never generate taxable income that can absorb the research credits at the shareholder level. Credits generated by the newly designated C corporation will be claimed on the corporate income tax return. Business entities that are considering a merger or acquisition should also address the impact of the TCJA changes to their research credits in the context of that planning.

International Tax

Another trade-off for reduced tax rates is apparent in the TCJA's new base broadening provisions, including the Global Intangible Low-Taxed Income (GILTI) regime and the Base Erosion and Anti-Abuse Tax (BEAT). After foreign tax credits, general business credits (including the research credit) may be used to lower total U.S. tax liability for GILTI inclusions. For purposes of GILTI, some of the limitations that apply to other tax incentives do not apply to research credits. Likewise, there are limits on the application of some business credits to reduce BEAT liability, but for years beginning before January 1, 2026, the research credit can be utilized against BEAT.

The Takeaway

While always an important consideration, the research credit's value to taxpayers has been enhanced by the recent tax reform legislation. Research credits now represent a significant opportunity for taxpayers to minimize their federal tax liabilities due to the elimination or limitation of many business deductions. In the context of the new tax landscape, it is critical that taxpayers and their providers understand how research credits can be utilized to reduce tax liabilities.

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The New Centralized Partnership Audit Rules

The Bipartisan Budget Act of 2015 completely revamped the partnership audit rules.

The new rules went into effect January 1, 2018, and the most dramatic change is that IRS will now be able to collect any unpaid tax directly from the partnership rather than from each partner. The new rules first apply to audits of 2018 and later partnership tax returns. The previous audit rules remain in existence for audits of pre-2018 taxable years.

The Unlimited Power of the Partnership Representative

Under the new procedure, partnership audits will be handled by a Partnership Representative (PR). The PR replaces the tax matters partner (TMP) for audits beginning in 2018 and is the sole person representing the partnership before IRS. The partners have no statutory rights to participate in the audit process or even get notice of the audit. Partners desiring to get notice of or be involved in an audit need to have the partnership agreement or other document mandate such involvement.

In addition, while the TMP had to be a partner in the partnership, the PR can be any person provided such person has a substantial presence in the U.S. In order to have a substantial presence in the U.S., the PR must be able to meet an IRS agent in the country at a reasonable time and place, must have a U.S. street address and phone number with an American area code, and must have a U.S. taxpayer identification number.

The final IRS regulations clarified that the PR can be the partnership itself or a disregarded entity (DRE) for tax purposes. If the partnership, a DRE or any business entity is the PR, a designated individual must also be appointed to represent it before IRS. IRS will deal with that individual alone and no one else on all audit matters. The final regulations do allow for the appointment by a power of attorney of an accountant or lawyer who can assist in the audit.

The PR and the designated individual will be included on the annual Form 1065, U.S. Return of Partnership Income. The partnership can change the designation for any subsequent year when the Form 1065 for that year is filed. Once made, the partnership can only alert IRS of a change when the IRS mails a notice of administrative proceeding (NAP) to the partnership, the partnership files for an administrative adjustment request (AAR) or the partnership is notified that IRS will undertake a review of their return.

Options on Collection of Tax Due

After IRS concludes the audit, it issues a final partnership adjustment (FPA) that reports the required adjustments. There are four different methods for how taxes owed as a result of the adjustments will be determined and collected.

The first payment method is a basic default rule that provides that the partnership pays the tax in the adjustment year, which is determined by IRS. This imputed underpayment is often different (and likely higher) from the total tax due if tax liability was determined at the partner level. To alleviate this disparity, the partnership can file a request with IRS within 270 days of the issuance of the FPA to lower the imputed underpayment by showing that a lower tax rate applies to certain partners. The partnership may also request lowering the imputed underpayment by showing that a partner may not owe any tax because of its status as a tax-exempt entity.

The second payment method allows the partnership to make an election to push out the tax liability arising from the FPA to the reviewed year partners. This push-out election must be made by the partnership within 45 days after issuance of the FPA. In this case, the partnership will issue adjusted information returns on Schedule K-1s to those reviewed year partners, which will be issued for the year in which the adjustment is made. That Schedule K-1 is then subject to a simplified amended return process. Although the adjusted Schedule K-1 may be issued in the current year, interest and penalties are due as if the tax were owed from the prior year.

The third payment method modifies the basic default rule if any reviewed year partner chooses within 270 days after issuance of the FPA to file an amended tax return for the reviewed year, which takes into account the partner's allocable share of the partnership adjustments and that partner pays the additional tax due. If this method is chosen, the imputed tax underpayment owed by the partnership is reduced to take into account that partner's share of that income.

The fourth option is a new pull-in procedure added by technical corrections included in the Consolidated Appropriations Act of 2018, which avoids filing new returns. Instead, it allows each partner to submit a recalculation of their reviewed year tax liability and pay any added amounts due. The PR can act on behalf of the partners in submitting such recalculation and payments to IRS. In all cases, if the partnership does not agree with the FPA, the PR can contest the FPA in court.

Election Out of New Audit Rules

Partnerships with 100 or fewer partners may elect out of the new rules. If the partnership does opt out, it must provide its partners with written notice within 30-days of making the decision. The ability to elect out is available only if each of the partners is an individual, a C corporation, an S corporation, the estate of a deceased partner, or a foreign entity that would be a C corporation if it was a U.S. corporation. If a partner is itself a partnership, then no election out is available. The election is made on a timely filed Form 1065.

The Takeaway

The new audit rules represent a substantial departure from the previous audit regime. There are many issues to be considered and given the enhanced power of the PR, care must be taken in the choice of a PR and a designated individual.

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Possible QSBS Silver Lining for Ordinary Income Options

Many employees of companies who own stock options tend to get their liquidity from those instruments in one of two scenarios.

Either (1) when the company is sold (and they cash in the options at that time) or, (2) if they need cash and decide to exercise their options and sell the stock immediately (which may only be an option with publicly traded companies with an established market for their shares).

In the second scenario, the requirement that the stock be held for at least five years to qualify for the Qualified Small Business Stock (QSBS) exclusion may not be met. However, under certain circumstances, including the fact pattern illustrated below, it may be possible to achieve tax benefits under the QSBS rules even with stock held less than five years.

For additional information on QSBS, visit our Qualified Small Business Stock (QSBS) site.

Stock Options and Ordinary Income

Taxpayer John holds founders' stock that meets all QSBS requirements and has been held for five years or more, thereby also qualifying for the QSBS exclusion. As represented by stock options, John also has a significant equity stake in the company, which is about to be sold.

John's founders' stock in the company has no tax basis and will generate $21 million in proceeds/gain. The company, although quite valuable today, has less than $50 million of tax basis in its assets and is otherwise a Qualified Small Business (as defined in Sec. 1202(d)). The stock options have a $1 million strike price (the price at which John can exercise the options) and will generate $4 million in gross proceeds. This will result in $3 million of ordinary income on the exercise of the options (over and above the $21 million founders' stock gain).

If John allows a buyer to buy out his stock options for $3 million (the $4 million gross proceeds minus the strike price), he will have ordinary income on that portion of the transaction—and employment-related taxes as well. None of that will be eligible for QSBS treatment. His $21 million gain from the sale of his founders' stock would generate a $10 million exclusion, leaving $11 million of taxable gains, taxable at 23.8% federally.

Planning – Exercise the Options Before the Sale

If John is confident that the sale of the company will go through and is comfortable paying the employee related withholding taxes upon exercise, he might consider exercising the stock options prior to the sale of the company. This exercise will give him $4 million of tax basis in those newly exercised shares. He will still have $3 million of ordinary income that will be taxable as a result of the exercise (unless the options are incentive stock options (ISOs), which will result in savings on employment taxes). However, the QSBS computation for the founders' shares will change.

John's founders' shares do qualify for the QSBS exclusion, but because Section 1202(b)(1) sets forth a gain exclusion limitation that is the greater of $10 million or 10 times the adjusted basis of QSBS stock sold during the year, his exclusion would be limited. Because the basis is zero, the total QSBS limitation would be $10 million if the stock options had not been exercised prior to the sale. However, John is also selling the shares he recently exercised which are QSBS stock as well (although the shares do not qualify for gain exclusion because of the five-year rule).

Section 1202(c) sets forth the definition of QSBS and this is the definition on which the gain exclusion limitation under Sec. 1202(b)(1) is based. It does not include a five-year holding requirement (that rule is in Sec. 1202(a)(1) and is not relevant to this analysis). Since the exercised options are being disposed of in the current year, 10 times their basis is part of the Sec. 1202(b) exclusion computation. Adjusted basis for the QSBS exclusion would be $4 million and the exclusion would then be 10 times that or $40 million—completely eliminating his gain on the $21 million of stock proceeds from the sale of his founders' shares. There will be no gain on the $4 million of option-shares sold as the basis and FMV at the time of the sale are both $4 million (remember $3 million of ordinary income was previously recognized upon exercise, increasing basis in the shares to $4 million).

The Takeaway

Employees of companies can be issued various types of equity compensation and it is important to understand how these different types of equity interplay with the requirements for obtaining the QSBS exclusion on the sale of QSBS stock. Even if certain tranches of stock do not qualify for QSBS exclusion, the stock can still qualify as QSBS stock and provide tax benefits to the employee. The concept illustrated by the above fact pattern is applicable in many situations—especially those where founders have experienced dilution coupled with the subsequent issuance of equity option grants. This is just one example in which this type of planning could work but it is essential that an individual consult with a tax advisor who is well-versed in the nuances of QSBS.

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Private Accounting Solutions 101

You are an investor/entrepreneur, and your business is growing fast.

You need someone to help you bring order to your financial records and to assist your tax consultants with assessing your overall financial position and strategy. Or maybe you run a growing family office. You have an administrative employee, but the job has become more complex and now you need an accounting staff person.

The types of Private Accounting Solutions (PAS) clients vary, but often the need becomes most apparent when financial complexities outpace internal competencies. Services offered range from diagnostic reviews, investment accounting, and consulting to more routine tasks such as the coordination of bill-paying and cash management. One important service most PAS clients require is the preparation of financial statements on some sort of regular schedule. This article will focus on the preparation of financial statements and how to find the right people for the job.

What Guides Financial Statement Presentation?

In the last few years, the American Institute of Certified Public Accountants (AICPA) rules related to the preparation of financial statements have changed significantly. Prior to the issuance of Statement on Standards for

Accounting and Review Services (SSARS) No. 21, Statement on Standards for Accounting and Review Services: Clarification and Recodification in late 2014, accountants in public practice who prepared financial statements were required to perform a compilation engagement in order to be in compliance with the standard set forth in SSARS No. 1, which was issued in late 1978. This outdated standard regulated the submission of financial statements to management or a third party by the accountant.

Why Is SSARS 21 Necessary?

In today's world of cloud computing and shared access to data between the client and the accountant, it has become increasingly more difficult to determine who actually submitted the financial statements, either to the client or to a third party. As a result, questions arose as to the oversight of the preparation and soundness of statements themselves. SSARS 21 was created and adopted, in part, to bring financial statement preparation standards in line with the (more current) auditing standards, which regulate the engagement to prepare financial statements rather than the act of submitting the statements.

What Does SSARS 21 Mean?

SSARS 21 contains four sections that clarify and revise the standards for reviews, compilations and engagements to prepare financial statements. The focus here will be SSARS 21 AR-C Section 70, Preparation of Financial Statements, which applies when the accountant is engaged to prepare financial statements as a standalone engagement, but is not engaged to perform an audit, review or compilation on those financial statements. Specifically, SSARS 21 – AR-C Section 70 states:

- Financial statements are to be issued without a report.
- Preparation of financial statements is a non-attest service.
- Issuance of prepared financial statements is permitted with or without disclosures to the client or a third party without restrictions.
- Requirements include:
  - Accountant must obtain an engagement letter signed by the client's management and the accountant (and include specific wording requirements).
  - Financial statements are to be issued without a report.
  - A no assurance legend must be included on each page of the financial statements.
  - (In most cases) the financial statements do not include a statement of cash flows (for GAAP departure) and a substantially all disclosures have been omitted legend must be on each page of the financial statements.
  - Accountant must be in public practice.
- The requirement for the accountant to be independent of the client or to determine independence has been omitted.

Because of these reporting changes, those in need of PAS services must now seek out providers that can meet these standards. For those clients working with providers who offer such services, the opportunity exists to take advantage of having both tax and accounting needs fulfilled by licensed professionals who are already subject to codes of ethics and regulations.

Do I Need Financial Statement Preparation?

The answer to this question obviously depends upon the situation. Multiple types of investments or business interests, significant real estate holdings, a potential liquidity event or a significant growth opportunity can all indicate a need for PAS. Mid-size family offices are often especially in need, as they typically would fit into some if not all of the above categories but may not have the full, in-house capabilities to deal with current accounting pronouncements, not to mention tax law changes.

How to Find the Right Provider?

In the world of PAS, no two situations are alike. Often services need to be easily adaptable to fit the specific needs of each family or individual. Providers with experience and insight into a broad spectrum of similarly situated clients can help guide individuals and family offices through identifying and implementing the appropriate solutions.

The Takeaway

SSARS 21, issued by the AICPA, brings accounting standards more in line with the needs of financial statement users, particularly among privately held companies. Under this standard it is more important than ever for those in need of PAS services to work with providers who can meet these requirements.

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