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Maximizing the Benefits of a Permanent Research Credit

In 1981 Congress enacted the Credit for Increasing Research Activities (the Research Credit) as an incentive to conduct research and development in the United States. The legislation was a temporary measure, aimed at preventing high paying R&D jobs from exiting the United States.

Over the next 34 years that temporary legislation expired nine times and was extended 16 times, usually in one or two year increments and often with retroactive effect. On December 18, 2015, Congress passed the *Protecting Americans from Tax Hikes Act of 2015*, finally making the Research Credit a permanent part of the Internal Revenue Code. The legislation enhanced Research Credit benefits for qualified small businesses, but otherwise reinstated the research credit regime that last expired on December 31, 2014. That regime includes the regular credit at 20% of the qualified spend in excess of a base determined by data from 1984 through 1988, and the alternative simplified credit (ASC) at 14% of the qualified spend that exceeds one-half of the prior three-year average.

If the existing regime has simply been made permanent, what has changed for most taxpayers? How should businesses respond to a permanent Research Credit? The primary complaint taxpayers lodged against the temporary Research Credit was the difficulty of planning for a short-term benefit. Financial forecasts and internal budgets could seldom rely on the promise of a reduction to a company's taxes when the Research Credit was due to expire or had already lapsed. As a result, most taxpayers adopted reactionary *look-back* policies around claiming Research Credit benefits, documenting last year's research activities to claim benefits with this year's return, only after the Research Credit was a legislative certainty for the credit year.

The Weakness of Look-Back Studies to Substantiate Research Credit Claims

For three decades this reactionary approach to the Research Credit contributed to controversy between taxpayers and IRS. In May 2008, IRS published the *Research Credit Claims Audit Techniques Guide* (RCCATG). The RCCATG identified the lack of *contemporaneous documentation* of qualified research activities as one of the greatest weaknesses of look-back Research Credit Studies. If IRS informed taxpayers that contemporaneous documentation is the preferred support for Research Credit claims, why have taxpayers continued to implement look-back studies that document last year's activity for this year's return?

The answer is that taxpayers have been reluctant to invest resources in developing a contemporaneous process while it was uncertain that Research Credit benefits would remain intact. As a result, credit eligible businesses fell into a familiar pattern of documenting research that occurred long ago, just in time to claim benefits by the extended filing deadline for the prior year's return. Taxpayers would then argue with IRS about the sufficiency of their records if their claim was examined. The delay in documenting qualified research frequently extended to multiple years if the taxpayer was in a loss position and could only carry the Research Credit forward for use in future tax years. These practices were specifically targeted by the RCCATG, which questioned the reliability of estimates and support documentation created years after the underlying research occurred. Untold numbers of exam adjustments and taxpayer disputes have resulted from this disconnect between IRS preference and taxpayer practice.

The Forward-Facing Model for Substantiating Research Credit Claims

Now that the Research Credit is a permanent benefit, there is good reason to re-evaluate reactionary policies that only result in increased controversy and reduced benefits. Eligible businesses have an opportunity to engage in real tax planning for long-term Research Credit benefits, and to adopt proactive policies and procedures that can minimize controversy and increase the percentage of claimed Research Credits that are sustained upon examination. Taxpayers can most effectively maximize benefits by giving IRS what it asked for in the RCCATG, namely contemporaneous documentation to support credits claimed.

Contemporaneous documentation of qualified research activities is best obtained through real-time analysis of potentially qualified research activities. Taxpayers across all industries should inventory current research and development efforts, and conduct a qualitative analysis of credit-eligible activities as the research is conducted. A financial analysis of qualified research expenses should be paired with the qualitative study when annual figures are finalized at year-end.

The advantages to a forward-facing model for substantiating Research Credit claims include:

- *Resilience to Organizational Change*: Turnover in R&D personnel, upgrades to computer systems and structural changes through acquisitions or dispositions of business divisions diminish the quality of the data

and documentation available to support the Research Credit if the information is first requested years after the qualified research was conducted. Real-time analysis of potentially qualified activities captures information that would otherwise be lost if not collected before organizational changes occurs.

- *Opportunities to Fill Gaps in Documentation*: Research personnel face competing demands on their time. Documentation of credit-eligible activities can become a low priority. Real-time analysis of credit-eligible activities alerts the tax department to gaps in available records to support Research Credit claims. Genuine contemporaneous documentation can be created to support qualified research that would otherwise be documented much later through a look-back study, or not be documented at all.
- *Enhanced Reliability of Estimates*: If research personnel do not keep timesheets, or if cost accounting systems do not track material and supplies and contractor expenses associated with research activities, estimates are used to quantify the amount of qualified research expense that should be included in the Research Credit claim. Periodic estimates made during the credit year are inherently more reliable than a single estimate made years after qualified research occurred.
- *Less Intrusive and More Efficient:* Traditional look-back studies employ lengthy surveys and interviews followed by detailed document requests that cover multiple years' worth of research activities. It can take days for research personnel to comply with these requests. The burden placed on R&D professionals can result in low levels of compliance with information requests, or data dumps of all documents in their possession. Neither extreme allows the tax department to efficiently compile contemporaneous support documentation for a Research Credit claim. Real-time analysis of qualified research only requires short periodic discussions with research personnel to take a few data points during the current tax year. Document requests relate to recent activities, making it easier to find and submit support documentation.

Optimizing Processes to Maximize the Value of a Permanent Research Credit

Taxpayers have long awaited a permanent Research Credit. Now that it is here, tax departments need to critically evaluate their policies and procedures around claiming the Research Credit. IRS is currently rethinking its approach to auditing tax returns, promising a move to campaign-based examinations. A subset of those campaigns will almost certainly focus on the Research Credit. A reactionary approach to substantiating claims with weak documentation produced years after research is conducted is likely to receive greater scrutiny under the new IRS procedures. The certainty of a permanent Research Credit is deserving of an investment in evaluations of new processes that will minimize controversy and maximize sustained benefits in the future.

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Newly Enacted PATH Act Increases Potential Refundable Credit for Corporations with AMT Credits

The newly enacted Protecting Americans from Tax Hikes of 2015 Act (PATH Act) extends the bonus depreciation provisions available to businesses and provides an expansion of the election to accelerate AMT credits in lieu of bonus depreciation.

Significant Benefits Provided as Part of New Tax Depreciation Legislation

On December 18th, President Obama signed into law the Protecting Americans from Tax Hikes of 2015 Act (PATH Act), which addresses various tax extender provisions that expired during tax year 2015. Among the numerous business provisions, the PATH Act retroactively reinstates the bonus depreciation deduction for tax year 2015 and extends the provision through 2019 (with an additional year for certain property with a longer production period). The Act provides a bonus depreciation percentage of 50% for property placed in service during 2015, 2016 and 2017

and phases down the available bonus depreciation percentage, to 40% in 2018, and 30% in 2019.

Qualified Improvement Property

The Act provides a permanent recovery period for qualified improvement property of 15-years beginning in 2016. This replaces prior temporary provisions for qualified leasehold, retail, and restaurant property. Improvements to the interior portion of a nonresidential building placed in service after the original placed-in-service date of the building receive a 15-year recovery period. The provision also allows bonus depreciation for qualified improvement property without regard to whether the improvements are property subject to a lease.

Election for Corporations to Claim AMT Credits in Lieu of Bonus Expanded

In addition, the provision significantly expands the ability of corporate taxpayers to elect to claim a refund of deferred AMT credits in lieu of bonus depreciation starting in 2016. A corporation can make an election to forego bonus and accelerated depreciation for *eligible qualified property* in exchange for a refundable credit of otherwise deferred AMT credits. A corporation that makes the election must forgo bonus depreciation and use the straight-line method for regular and AMT tax purposes with respect to the eligible qualified property.

For tax years beginning in 2016, the Act modifies the AMT rules to increase the potential amount of unused AMT credits that an eligible corporation can claim in lieu of bonus depreciation. Under the modified rules, the deferred AMT credits that a corporation can exchange for bonus and accelerated depreciation are attributable to tax years beginning before 2016.

The amount of pre-2016 AMT credits presently allowed for a tax year is increased by the bonus depreciation amount for the tax year. The bonus depreciation amount is equal to 20% of the difference between depreciation allowed for eligible qualified property if bonus depreciation was allowed and depreciation for eligible qualified property if no bonus depreciation was allowed. For example, if $6,250,000 of qualified five-year assets were placed in service in 2016, the bonus depreciation amount is $500,000. The bonus depreciation amount is computed as follows:

Qualified assets place in-service	$6,250,000
50% bonus depreciation	$3,125,000
20% depreciation on remaining tax basis	$625,000
Total depreciation with bonus	**$3,750,000**
Less (depreciation without bonus)	($1,250,000)
Difference	$2,500,000
Multiplied by 20% equals bonus depreciation amount	$500,000

The bonus depreciation amount for a tax year is limited to 50% of the minimum tax credit for the first taxable year ending after December 31, 2015 (determined before application of any tax liability limitation), or the remaining minimum tax credit from taxable years ending before January 1, 2016 (whichever is less).

All corporations treated as a single employer are treated as one taxpayer for purposes of the limitation as well as for making the election. In the case of a partnership having a single corporate partner owning more than 50% of the

partnership, the corporate partner takes its share of the partnership's eligible qualified property in computing its bonus depreciation amount. Income from underlying partnerships of an electing corporation must be determined based on straight-line depreciation for eligible qualified property and bonus depreciation does not apply.

As originally enacted, the bonus depreciation amount was limited to the lesser of $30 million or 6% of the minimum tax credits generated in taxable years before 2006. The removal of the $30 million cap and the increase in limitation from 6% to 50% of AMT credits generated prior to 2016 (versus 2006) presents an opportunity for taxpayers with pre-2016 AMT credit carryforwards to receive a refund if sufficient eligible qualified property is placed in service.

The amount of eligible qualified property that must be placed in service to maximize the refund varies depending on the recovery period. On average, a taxpayer that places eligible qualified property in service with a cost that is six to seven times the amount of the taxpayer's AMT credit carryforward in 2016 and 2017 will be able to use its entire AMT credit carryforward over a two-year period.

The Takeaway

The legislation provides a level of certainty with respect to tax depreciation that has not existed for quite some time. The bonus depreciation deduction has recently been part of year-end extender packages, which have retroactively reinstated bonus depreciation and left taxpayers speculating on its availability from year to year. The five-year extension through tax year 2019 allows taxpayers to better plan for future capital expenditures.

Corporations with AMT credit carryforwards should carefully evaluate potential benefits under the expanded AMT in lieu of electing bonus depreciation. The potential for refund of AMT credits may be an attractive option for many corporations with AMT credit carryforwards. Corporations should also consider how a potential 2016 election to claim deferred AMT credits in lieu of bonus depreciation would impact any valuation allowances against credit carryforwards for 2015 financial statement purposes.

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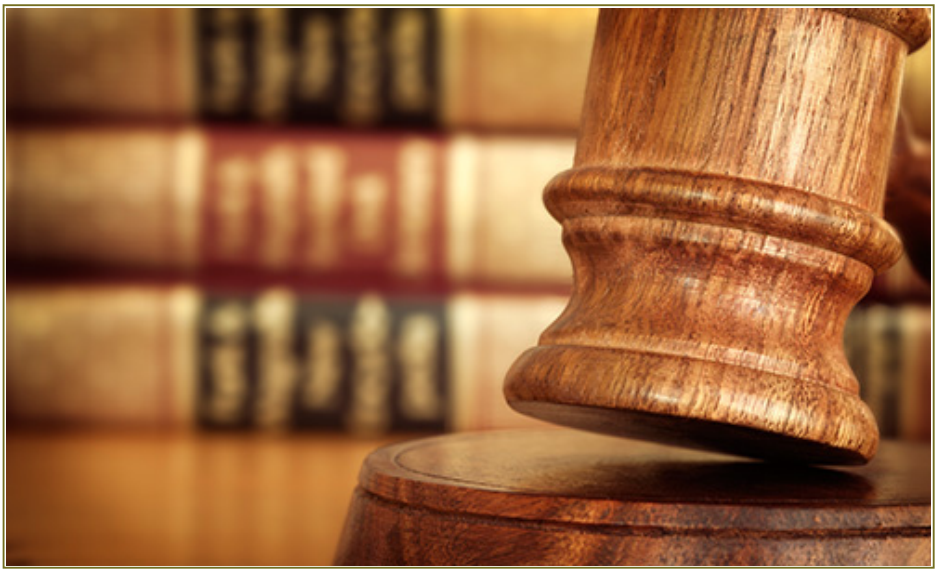
The Deductibility of Legal Expenses



In certain cases Internal Revenue Code allows for the deduction of legal fees on an individual tax return through Schedules A, C, or E and in other cases on Schedule D.

Where the legal fees are deducted on the return is determined by the source of the claim that gives rise to the legal fees at issue. Legal fees associated with the production of income, including wages, or relating to charitable contributions, are deducted on Schedule A. Fees that are connected to a taxpayer's trade or business, rental, or royalty activity may be deducted on either Schedule C (sole proprietorship) or Schedule E. Finally, fees that are connected with capital expenditures or property are capitalized and reported on Schedule D as an increase in the property's basis when the property is sold.

Schedule A (Production of Income)

Legal expenses are deductible on Schedule A of an individual's income tax return when they are associated with the production or collection of income; the management, conservation, or maintenance of property held for the production of income; or in connection with the determination, collection, or refund of any tax. These expenses are classified as miscellaneous itemized deductions and subject to both the 2% and 3% limitations. In addition, these legal fees are also add-backs for Alternative Minimum Tax purposes.

Expenses related to estate planning may be deducted on Schedule A. However, estate planning is generally not solely concerned with tax matters. The portion of the fees that are allocable to tax planning should be separated from the portion allocable to other estate planning work and only the portion related to tax advice can be properly deducted on Schedule A.

The origin of the claim with respect to the expense determines whether or not it is related to the production of income. For example, legal fees associated with a property settlement in a divorce or separation proceeding are generally not deductible under the origin-of-the-claim rule because they arise from a personal matter even though they may affect income-producing property. However, legal fees incurred in order to collect or recover taxable income, such as alimony, are deductible.

Schedule A (Charitable Contributions)

Legal fees incurred in a transaction related to a charitable contribution, such as structuring of a gift to a charitable land trust, may be deductible as charitable contributions. However, it is a complex determination that must be studied carefully. For example, if the taxpayer directly pays the Land Trust's legal fees associated with the transfer, the fees are deductible as a charitable contribution. However, if the taxpayer incurs personal legal fees associated with this transfer, the most likely result would be that the fees would be deductible as miscellaneous itemized deductions rather than charitable deductions on Schedule A.

Schedule C (Trade or Business Expense)

Legal expenses are deductible on Schedule C when they are:

1. Ordinary;
2. Necessary;
3. Paid by the taxpayer during the tax year;
4. Incurred as part of the taxpayer's trade or business;
5. Connected with or a proximate result from that trade or business.

Schedule E Deduction (Rental and Royalty Expenses, Unreimbursed Partnership and S-Corporation Expenses and Trade or Business expenses in Limited Circumstances)

A taxpayer who reports rental or royalty income on Schedule E, Part I, or Partnership or S corporation income on Schedule E, Part II for Partnerships or S corporations in which he or she actively participates will likewise deduct unreimbursed legal expenses incurred through these activities on Schedule E. Note, however, that in certain cases legal expenses related to property must be capitalized and added to the property's basis, as discussed later.

If a taxpayer is a limited partner in a partnership with no involvement in the management of the partnership, any unreimbursed legal expenses incurred by the partner must be deducted on Schedule A instead of Schedule E.

According to IRS the limited partners in a partnership are primarily investors, thus not involved in a trade or business. Ultimately the taxpayer's involvement in the partnerships operations and management must be analyzed in determining if it rises to the level of participation that would allow for a deduction on Schedule E.

Schedule D Capitalization (Capital Expenditures)

Legal expenses that are incurred defending or perfecting title to capital property, in acquisition or disposition of capital property, or in developing or improving capital property are not expenses that are deductible, and must be capitalized instead. These expenses are added to basis and taken into account for tax purposes either through depreciation or by reducing capital gain (or increasing capital loss) when the property is sold. In cases where litigation involves the defense, acquisition, disposition, or improvement of capital property, the origin of the claim, not the taxpayer's primary purpose in litigating is the prevailing test to determine whether fees can be deducted or capitalized.

Conclusion

There are many different scenarios where taxpayers may incur legal expenses. Careful consideration must be given to the facts and circumstances surrounding any scenario that involves litigation or legal advice and how to determine if and when those expenses may be deductible.

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