

Impact Of Recent Tax Legislation On Life Sciences Companies

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Two recent tax legislation changes are particularly impactful on tech and life sciences companies that rely upon the outcome of their ongoing R&D projects.

Here are the changes and some steps and strategies companies can take to optimize their tax benefit and mitigate adverse impacts of the new legislation. The two changes are:

1) EFFECTIVE FOR TAX YEARS BEGINNING AFTER DEC. 31, 2021, TAXPAYERS ARE NOW REQUIRED TO CAPITALIZE SECTION 174 R&D COSTS

The 2017 Tax Cuts and Jobs Act (TCJA) preserved the R&D tax credit and made no direct changes to it. However, in order to pay for the lower corporate tax rate and other incentives, the TCJA also included a revenue increasing provision which will now begin dramatically impacting most taxpayers from the 2022 tax year and beyond. For tax years beginning after Dec. 31, 2021, the TCJA has eliminated the taxpayer's option to deduct R&D expenditures currently and requires they be charged to a capital account and amortized over five years (15 years for foreign research expenditures) beginning from the midpoint of the tax year in which the expense was incurred. Prior to the TCJA, taxpayers could choose to immediately expense their R&D expenditures or to treat these expenditures as deferred expenses and amortize them over a period of at least 60 months. The Section 174

modifications also will now require that all software development costs be included as research or experimental expenditures and amortized accordingly. Before, TCJA software development costs could be capitalized and amortized over three years. Furthermore, any abandoned or retired property disposed of during its amortization period must continue to be amortized, rather than being deducted in the tax year of disposal. As a result of these changes to Section 174, taxpayers will need to evaluate the impacts to their estimated tax payments and quarterly tax provision calculations in order to prevent underpayment and interest penalties.

Section 174 expenses are much broader in scope than those of Section 41 (R&D tax credit) expenses, which presents the primary challenge for taxpayers. Section 174 eligible expenditures include all costs (foreign and domestic) incidental to product development/improvement, including:

- direct R&D costs (wages, supplies, and contract research)
- indirect R&D costs (overhead, utilities, rent, depreciation, patent fees, etc.)
- all software development costs (internal or external use).

Section 41 eligible expenditures must be incurred in the U.S. and are a subset of Section 174 expenses. They must meet the uncertainty requirement of Section 174 as well as the additional three Section 41 requirements — being a business component of the taxpayer, relying on technological activities, and involving a process of experimentation.

Section 41 eligible expenditures include:

- U.S.-based R&D wages (for performing or directly supporting or supervising qualified research activities)
- U.S.-based R&D supplies (exhausted in experimentation, used to build prototypes, trial production runs)
- U.S.-based contract research (allowed up to 65% of expense for third-party research activities on behalf of taxpayer)

STEPS, PLANNING, & PREPARATION

The following steps can be taken to help identify and estimate Section 174 expenses:

- review financial statements to identify core R&D expenses by department
- review trial balance for R&E (research & experimentation) accounts
- review general ledger data for R&E accounts
- review transaction level detail to determine applicability of Section 174
- review overseas payroll data to identify foreign employees performing similar R&E activities as U.S. counterparts.

Proactive Operational Steps to Consider

- Require vendor invoices to include a breakout of foreign and domestic costs, including physical location of resources performing qualified contract research.
- Relocate foreign R&D expenditures to the U.S. to allow a five-year amortization period.
- Modify third-party contract terms to reflect asset acquisition, not R&D expenditure.
- Develop a process for allocating overhead, payroll, rent to Section 174 treatment.

The documentation burden will likely shift from illustrating how activities qualify based on Section 174 criteria to showing an exhaustive process was undertaken that proves all Section 174 eligible expenses were identified and included.

State and Local Tax Implications

Different states will likely have varying conformities to the new Section 174 provision. Some states have rolling conformity to the Internal Revenue Code and will likely require the capitalization of R&E expenditures in accordance with the new provision, while other states do not automatically conform and may wait for the outcome of legislative action or simply decide to decouple from the capitalization requirement.

Interplay with the R&D Tax Credit

On the bright side, the R&D tax credit may be a useful tool for helping offset the additional tax burden created by the new capitalization and amortization requirements of Sec 174. Where the R&D tax credit has not been utilized by companies with historical operating losses, such as many tech and life sciences

startups, claiming R&D tax credits for the first time may propel some of these companies into a taxable income situation after their net operating losses are burned through.

Additionally, the recently passed Inflation Reduction Act of 2022 provides an enhanced R&D payroll tax credit for qualified small businesses. This new legislation doubles the taxpayer opportunity from \$1.25 million to \$2.5 million over five years, which can be used to offset Social Security and Medicare taxes.

2) NEW DOCUMENTATION REQUIREMENTS WHEN AMENDING PREVIOUSLY FILED TAX RETURNS TO CLAIM MISSED R&D TAX CREDIT OPPORTUNITIES

Taxpayers who were eligible for the R&D tax credit in prior years but didn't claim it may file amended returns to try to claim these missed credits. Often these are tech and life sciences startups. The decision to amend will need to be weighed much more heavily, however, as the IRS has significantly tightened the requirements for filing R&D tax credit refund claims.

To be considered sufficient, a refund claim must now include:

- identification of all business components and new or improved products and processes on which the claim is based
- for each business component, identification of specific research activities performed, all of the individuals who performed them, and the specific information each individual was seeking to discover
- total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the amended claim year — these can be included in the form 6765.

Each of these “items of information” must be submitted when the refund claim is filed, along with a declaration, signed under penalty of perjury, verifying their accuracy.