

Scenario 3 – HHD as research scientist

Good morning, Mr. Harris. Thanks for making time for me.

You're very welcome Dr. Franklin. I'm very glad that you're considering our firm for your accounting needs.

Well, the reason I'm reaching out is that we got an inquiry from a company that specializes in the research and development credit. After a brief conversation, they told us that we should have been taking that credit all along, and it could have saved us thousands of dollars. They said our old firm should have been doing this, and so we decided to let them go and seek better representation.

Didn't that company try to convince you to let them apply for the credits for you?

They did indeed! But they wanted to take 15% of the amount of the credit as a fee, and their promise of audit support meant nothing more than supplying some workpapers. And they were so certain that we would qualify based on just that brief conversation! It just gave me a bad feeling. I thought a full-service accounting firm might be able to give me a more balanced picture of our options.

Those are some finely-tuned instincts you have there, doctor! Our experience is that those companies are VERY aggressive in claiming the credit for activities that may not qualify as research under the regulations. They don't do anything that's openly fraudulent (that I've seen), but they stretch the definitions more than I would be comfortable with. And the workpapers that I've seen from them to support the amounts claimed are basically boilerplate, and don't seem to fully address a specific client's situation.

Well I'm certainly glad I came to you, then! Although, I will say that there's no stretch in calling our business a research activity. Along with my colleagues, Drs. Watson and Crick, I've been doing some cutting-edge genetic research for a couple of years, and we've made some remarkable discoveries.

That's very exciting! It's hard to believe your prior accountant never discussed this issue with you.

They never even brought it up!

So you mentioned that you had been in business for a couple of years?

Yes, we started the company in 2019. Before that, we all had jobs at a university, but we decided to strike out on our own.

And have you been able to generate any revenue yet?

Well, we got some grant money for one research project, but other than that, the funds to support our research have come from outside investors.

Discuss research for hire rules. So, aside from that small project, you own the results of your research and bear the risk of loss?

That's correct.

Well, it seems obvious that your work would qualify, but let me quickly go over the components of qualified research. *Discuss 4 components.*

- Develop or improve a new or existing product or process
- Eliminate technical uncertainty
- Process of experimentation
- Technological in nature

We certainly do meet those qualifications.

How is your business organized? A corporation? A partnership?

It's a partnership....well, an LLC, I believe.

Very good. So let's talk about how the credit works. *Discuss credit rules, reduced credit, amended returns, etc.*

That all sounds very complicated. But we could still get a big credit, right?

Well, you could generate one. But it wouldn't do you any good right away. And since you can't elect the reduced credit on an amended return, you would have to amend returns for prior years and reduce your loss by the amount of the credit claimed. A credit that you won't yet be able to use. *Discuss carryover of unused credit, payroll tax election – must be timely filed*

Well that's disappointing.

It is, but there's another wrinkle that's new for 2022. Up to this point, R&D expenses have been fully deductible in the year they are incurred. That rule has actually allowed immediate deduction of costs that otherwise would have been capitalized. But as part of the Tax Cuts and Jobs Act, beginning in 2022, all R&D costs will have to be capitalized and amortized over 5 years. And that's only if the work is done in the US. If it's foreign research, you have to amortize it over FIFTEEN years.

Let me make sure I understand this. If we have a million dollars of R&D expenses (which would be almost all of our expenses) in 2021 and 2022, for 2021 we could deduct the entire million as a loss, but for 2022, we'd only be able to deduct one fifth of that amount?

Actually, it's worse than that – you only get a half year of amortization in the first year. Then you get 4 full years, then another half year at the end.

So we lose out on \$900,000 of deductions in 2022 just because it's R&D costs instead of just regular business expenses?

I'm afraid that's correct. And if your activity stayed steady for the next several years, it would be 2027 before you'd be deducting a full million dollars per year for R&D.

But our investors count on those losses being allocated to them and using them to offset their other income!

That's true for a lot of companies like yours. If Congress doesn't fix this soon, the available capital for R&D startups may start to dwindle.

So Congress might fix it?

They might. Bills have been proposed to do just that. But counting on Congress to enact effective and timely legislation to fix obvious problems has historically not been the surest of bets. We should prepare for the worst.

So what can we do?

Well, let's look at your situation. As you have been filing, you are generating a large loss that is fully deductible each year for your investors, and you're not generating a credit. By claiming your costs as R&D, you'd be generating a credit that – if you claimed it – would do your investors no good for many years, and would cause positive adjustments to income in prior years if you amended it. You could take some of the credit against payroll taxes for a few years, but your payroll provider might balk. And you'd be substantially reducing losses available to your investors in future years – potentially. Is there a way that perhaps your expenses.....AREN'T R&D?

I think that would be very hard to argue. I think this is hilarious. I came in here hoping for you to reassure me that our activity DOES qualify as R&D, and now I hope you'll tell me it DOESN'T!

I know! This year is causing some strange conversations for me! I'm not saying that claiming the R&D credit is a completely bad thing. It's likely that Congress will fix this amortization issue, and I'll take a dollar of credit for 40 cents in lost deductions any day – even if I have to wait a little longer to realize it. But most importantly, I can't sign a return saying that costs AREN'T R&D when I know that in fact they ARE.

Hmmmm....maybe I should give our old accountant a call? 😊