

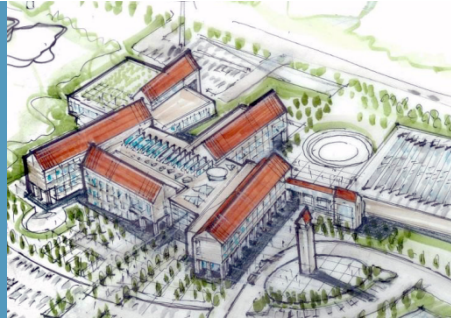
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Things Happen

University Industry
Demonstration Partnership
Research Credit Presentation
Loren Oppen | Ryan Riehl
March 25, 2020

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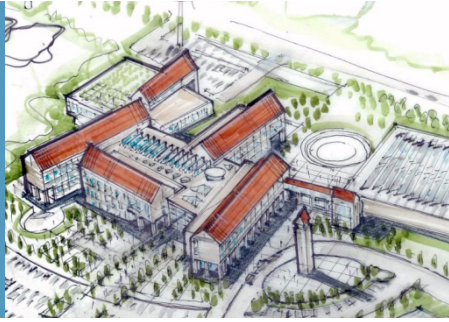


WE DO MORE THAN ADVISE

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Things Happen

Federal Income Tax Credits for Research Expenditures

Tax Credits Available to Industry for
Payments to Universities and
Other Organizations for Research
Services



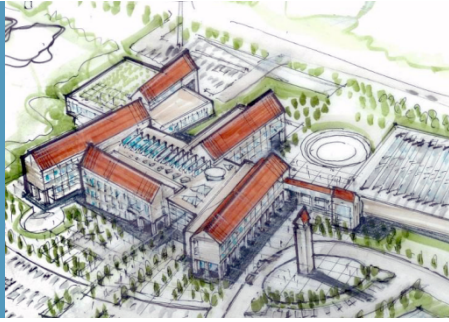
Credits Available to Industry

Three categories of tax credits are available:

Cash payments to “Qualified Organizations” (e.g. universities) for “Basic Research”

Money and property contributed for “Qualified (Applied) Research”

Contributions to an “energy consortium” to conduct energy research in the public interest

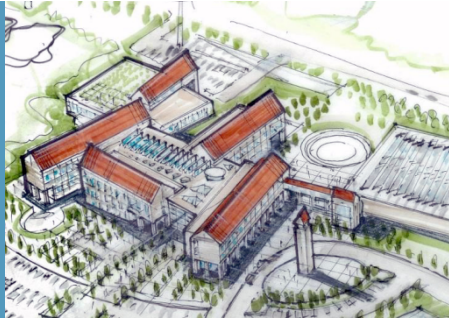


Taxpayers Entitled to the Basic Research Credit

A taxpayer entitled to the basic research credit must be a corporation.

Ineligible for the basic research credit are:

- An S corporation
- A personal holding company
- A service organization the principal business of which is the performance of services

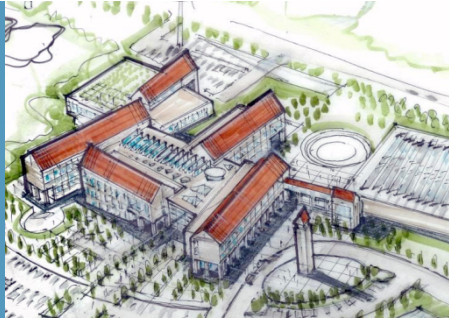


Industry Expenditures

For 2016,
the United
States
Treasury
Department
reported:

Taxpayer expenditures of
\$55 billion for Qualified
(Applied) Research

Taxpayer expenditures of
\$167 million for Basic
Research



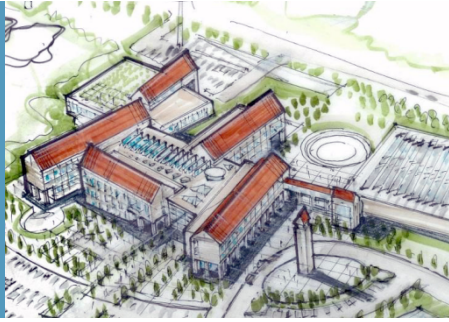
Taxpayers That Funded Basic Research

Information
businesses:
\$80,000,000

Manufacturing:
\$40,000,000

Professional,
scientific, and
technical services:
\$30,000,000

Miscellaneous:
\$17,000,000

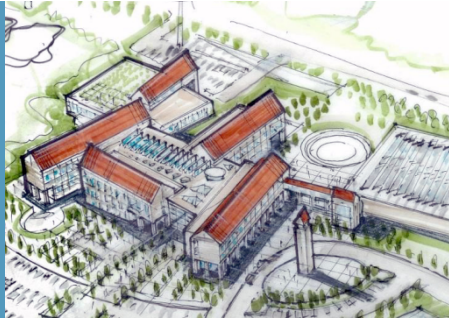


Definition of “Basic Research”

Basic research must have the following features:

Original investigation for the advancement of scientific knowledge

Not having a specific commercial objective

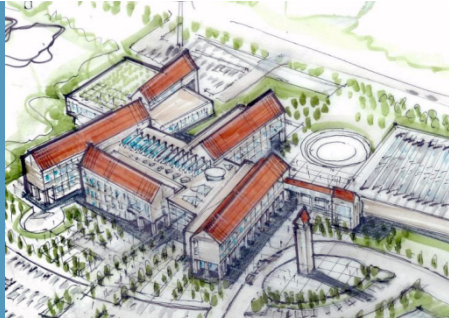


Exclusions from Basic Research

Ineligible
contributions:

Research conducted
outside the United
States

Research in the social
sciences, arts, and
humanities

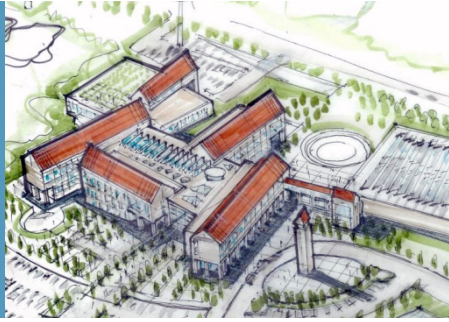


Basic Research Payment

The Basic Research Credit is calculated by reference to the “Basic Research Payment” to a Qualified Organization.

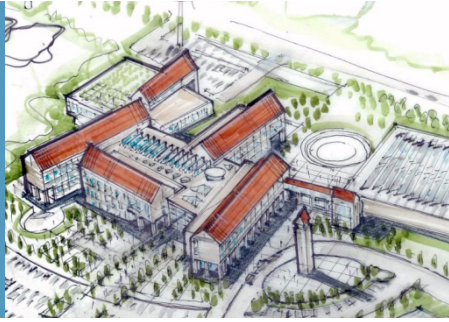
A Basic Research Payment must be cash. It cannot be property. The Basic Research Payment taken into account for credit purposes is 100%, and not a lesser amount of the cash paid.

The Basic Research Payment must be made pursuant to a written agreement and provide that the Qualified Organization will perform the research.



History

- The research credit was enacted in 1981.
- Calculation of the credit combined both expenditures for applied research and basic research.
- Only 65% of expenditures for basic research were then allowed.
- Property as well as money was counted for the basic credit.
- Congress revised the research credit in 1986 to separate the Basic Research credit calculation from the Qualified (Applied) Research credit calculation.
- Reason: “The [Congressional] committee believes it is desirable to provide increased tax incentives for corporate cash expenditures for university basic research”

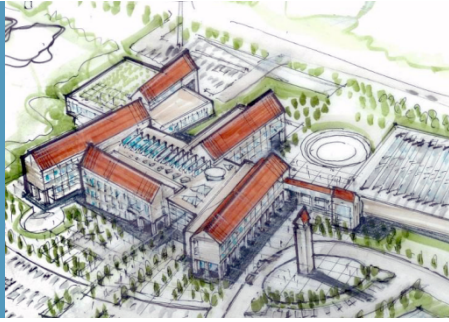


Qualified (Applied) Research Definition

Research to develop or improve a product or production system

Use of physical or biological sciences or engineering to eliminate uncertainty in the capability, method, or design of a product or production system

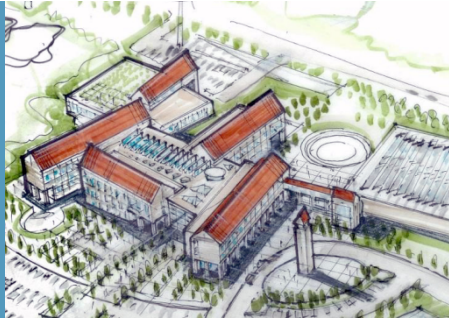
Substantially all the research activities must constitute a process of experimentation



Qualified (Applied) Research

Just as a university or other eligible organization can perform Basic Research for a business taxpayer, a university or other eligible organization can perform Qualified (Applied) Research for a business taxpayer.

The calculation of the tax benefit for Qualified (Applied) Research is different, however, from the calculation of the tax benefit for Basic Research.

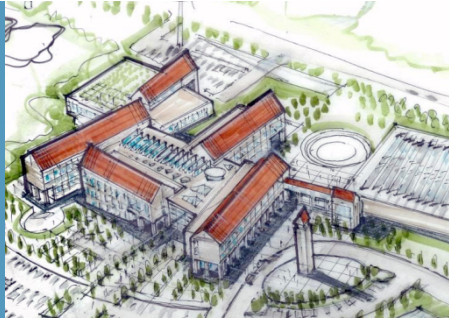


Tax Law Difference Between Qualified (Applied) Research and Basic Research

Congress Used the National Science Foundation definition to draft the tax law relating to the research credit.

The National Science Foundation definition of “research” may include both Qualified (Applied) Research and Basic Research.

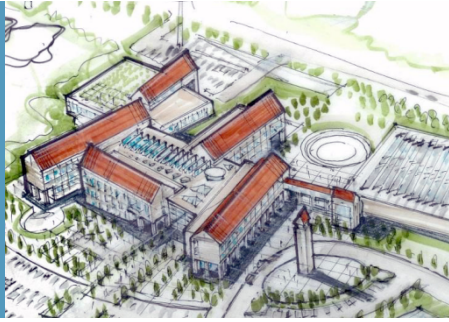
The difference between the two sometimes may be blurry.



Taxpayer General Preference for the Basic Research Credit

100% of amounts paid by a taxpayer to a Qualified Organization for Basic Research are taken into account, as compared with 65% for Qualified (Applied) Research.

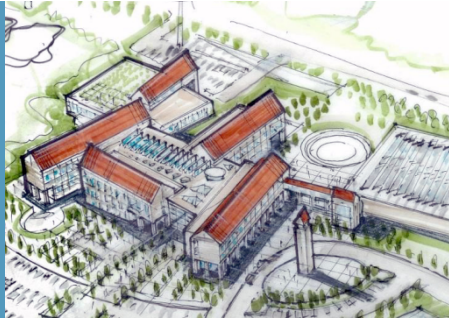
A Basic Research payment may include prepayments to a Qualified Organization for future years' research, as compared with Qualified (Applied) Research for which prepayments may not be taken into account.



Taxpayer General Preference for the Basic Research Credit

To claim the Qualified (Applied) Research credit, a taxpayer has to carry on a trade or business, which means that the taxpayer is currently ready to conduct business and serve customers.

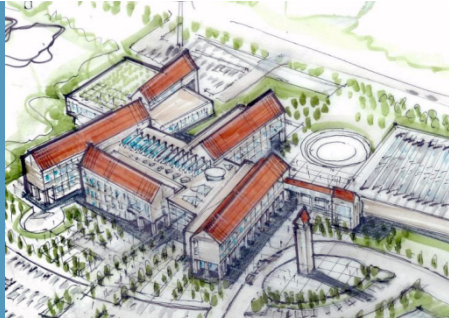
A taxpayer that is a start-up and not ready to serve customers cannot claim the Qualified Research (Applied) Credit, BUT ...



Taxpayer General Preference for the Basic Research Credit

A start-up not yet carrying on business can claim the Basic Research credit for amounts paid to a Qualified Organization.

The start-up can carry forward the Basic Research credits that it accrues to future tax years and apply the credits when the start-up starts to incur tax liabilities in future tax years.

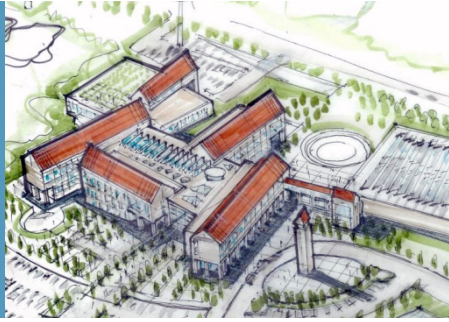


Taxpayer General Preference for the Basic Research Credit

A taxpayer performing research *in-house* that is not identified with a product or production system may be ineligible to claim the Qualified (Applied) Research credit.

The taxpayer performing research *in-house* also would be ineligible to claim the Basic Research credit because no payment would have been made to a Qualified Organization.

For that reason, payment to a Qualified Organization for performance of the research not identified with a product or production system might be preferable from a tax perspective.

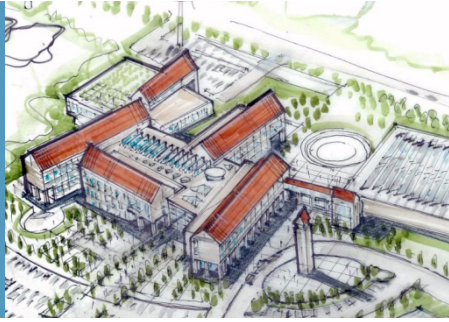


IRS Challenges to the Research Credit

The IRS has been using substantial resources to examine taxpayers who claim the Qualified (Applied) Research credit.

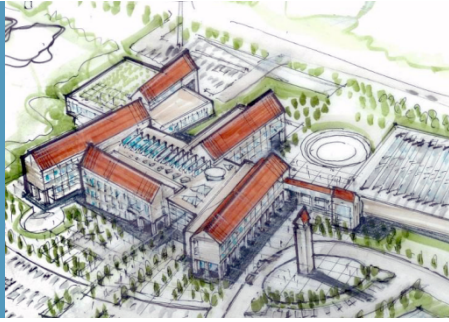
The IRS has now initiated a campaign to scrutinize taxpayer claims of the Qualified (Applied) Research credit to an even greater degree.

But no court case has been decided or ruling issued with respect to the Basic Research credit.



Qualified Organizations that May Perform Basic Research

There are four types Qualified Organizations that may perform Basic Research for which a taxpayer that has funded the research may claim a tax credit.



Educational Institutions

College,
university,
or
vocational
school
that:

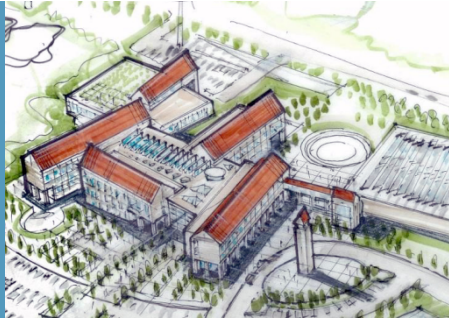
Maintains a regular faculty, curriculum, and educational activities

Is a public or other nonprofit institution

Has enrolled students having high school diplomas

Offers degreed programs, and

Performs scientific research



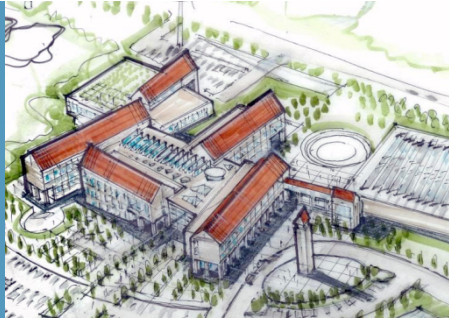
Scientific Research Organizations

Organization operated exclusively to conduct scientific research,

Exempt from income tax,

Not a private foundation, and

Actually performs scientific research



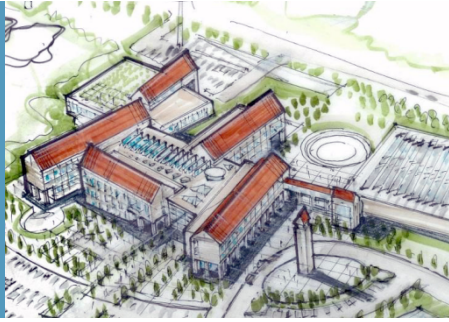
Scientific Tax-Exempt Organizations

Tax-exempt corporation, business league, etc., organized and operated *primarily* to promote scientific research through grants and contracts

The grants and contracts must be with an educational institution pursuant to a written agreement

The tax-exempt corporation must expend substantially all its funds for basic research

The tax-exempt corporation cannot be a private foundation



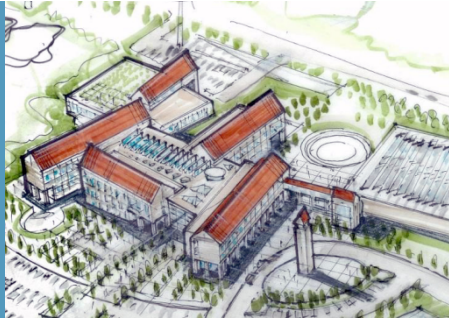
Certain Grant Organizations

Tax-exempt organization

Established and maintained by a tax-exempt organization before July 10, 1981

Organized and operated *exclusively* to make grants to educational institutions for basic research

Elects to be treated as a private foundation

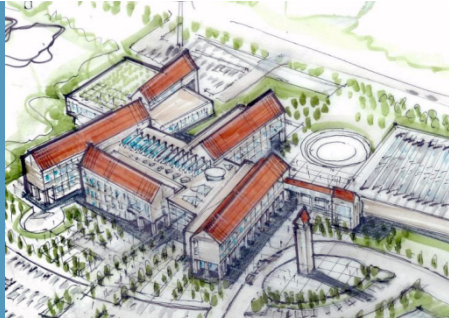


Calculation of Basic Research Credit

Example: Assume taxpayer makes \$500 Basic Research Payment in 2019 to Big University.

Credit equals 20% of the Basic Research Payment MINUS the Qualified Organization Base Period Amount.

The Qualified Organization Base Amount incentivizes the taxpayer to increase its Basic Research Payment over its Base Period Amount.

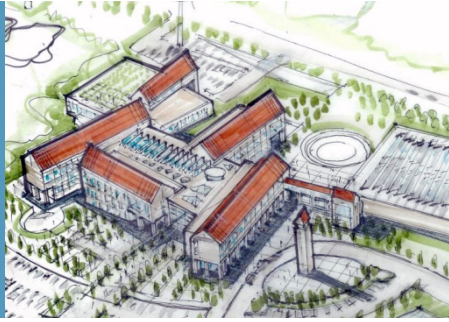


Calculation of Basic Research Credit

The Qualified Organization Base Period Amount (the hurdle over which the taxpayer has to get over) has two parts:

The minimum basic research amount, plus

The maintenance-of-effort amount



Calculation of Basic Research Credit

Example of calculation of Minimum Basic Research Amount:

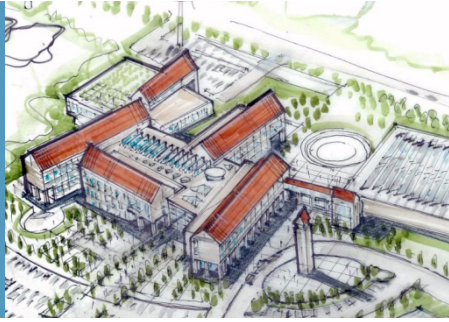
Taxpayer was organized in 1980

Base Period is the 3-year period 1981, 1982, 1983

Average in-house research expenses were \$1000 during the base period

Average contract research expenses were \$500 during the base period

1% of \$1500 = \$15



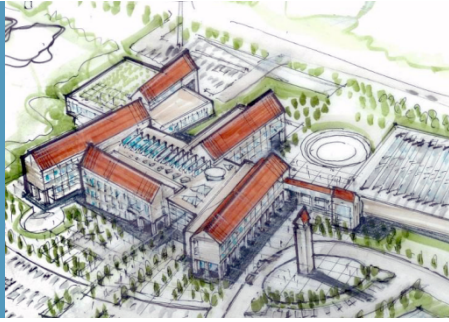
Calculation of Basic Research Credit

Calculation of Minimum Basic Research Amount (continued)

Amount the taxpayer treated as contract research expense under the pre-1986 law = \$10

Note: Pre-1986 had a different definition of contract research expense

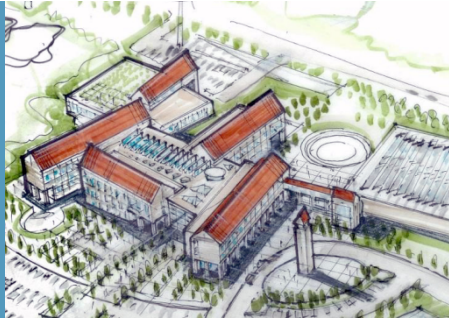
\$15 is the Minimum Basic Research Amount because the greater of the first calculation and the second calculation is selected.



Calculation of Basic Research Credit

The second part of the Qualified Organization Base Period Amount is the Maintenance-of-Effort Amount.

Congress wanted to ensure that a taxpayer that had historically made non-designated payments to a university would not in the current year stop making non-designated payments, which are not creditable, and make them instead as Basic Research payments to the university.



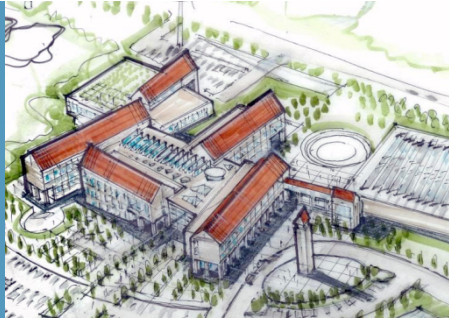
Calculation of Basic Research Credit

Non-designated university payments for 1981, 1982, 1983 = \$60.

Yearly average of \$20 times cost of living adjustment for the taxable year – 1.5 = \$30.

Amount of non-designated university payments taxpayer made in 2019 = \$10.

The Maintenance Effort Amount is \$20 (\$30 - \$10)



Calculation of Basic Research Credit

Current Tax Year 2019:

Basic Research Payment to Big University: \$500

Qualified Organization Base Period Amount:

- Minimum Basic Research Amount: (\$15)
- Maintenance-of- Effort Amount: (\$20)

Basic Research Payments Taken into Account: \$465



Calculation of Basic Research Credit

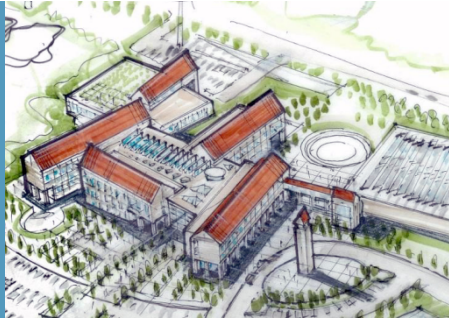
Basic Research Credit Payments Over the Base Period Amount = \$465

Credit Rate: 20%

Credit: \$93

The taxpayer must reduce its tax deduction for research expenses by \$93. Or, a taxpayer may elect to reduce the \$93 credit by an amount equal to the corporate tax rate times \$93.

The reason for the election is that a taxpayer cannot get a credit and a deduction for the same dollar of research expenditures.



Final Comments

The Basic Research credit is an inducement for established businesses and start-ups to pay universities and other qualified organizations to conduct research for them.

The Basic Research credit also may be used by universities and other qualified organizations to entice corporations to contract out research services.



Questions



Loren M. Opper, Of Counsel

+1.313.496.7858 | opper@millercanfield.com

When it comes to tax issues, Loren Opper is widely recognized as one of the leading legal experts in the United States with an extensive prior background in both the private and public sectors.

During a more than 35-year career at Ford Motor Co., most recently as director of IRS Audits, Appeals and Litigation, Loren was responsible for handling all of the automaker's complex federal tax issues. Currently his practice focuses on federal tax controversies, including income and employment taxes in the federal courts and matters within the Internal Revenue Service, including examinations and administrative appeals.



Ryan J. Riehl, Principal

+1.313.496.7539 | riehl@millercanfield.com

Ryan Riehl focuses his practice on federal and state of Michigan tax issues. He specializes in partnership taxation, like-kind exchanges and other real estate tax matters, corporate acquisitions, dispositions and reorganizations, research and development tax credits and international tax planning for both U.S. companies conducting business abroad and non-residents with U.S. business activities.



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