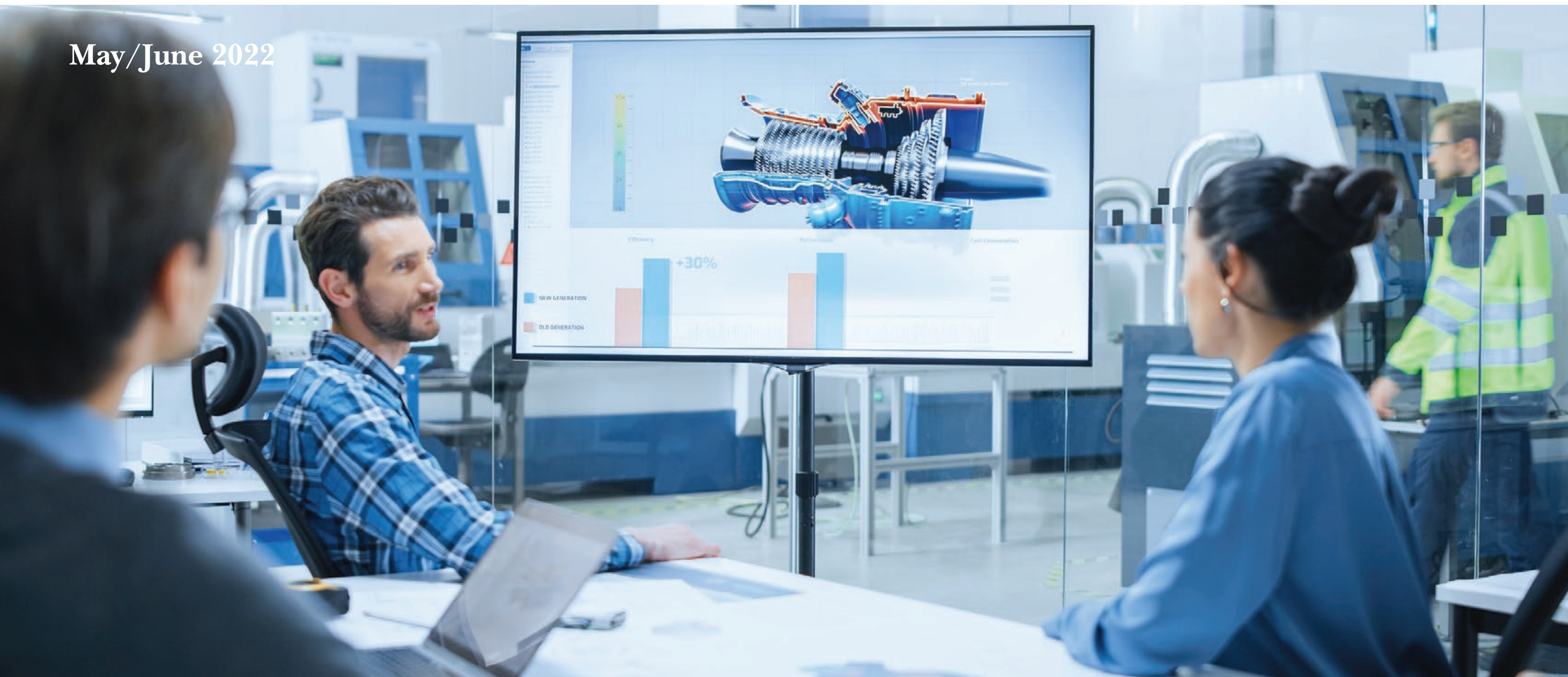
TAX IMPACT



May/June 2022

Research credits

IRS tightens documentation requirements for refund claims

Business succession and estate planning go hand-in-hand

Are you making the most of your 401(k) plan?

Tax Tips

Research credits

IRS tightens documentation requirements for refund claims

In recent guidance, the IRS has imposed strict new documentation requirements on businesses that file refund claims for federal research credits. These tax breaks are often referred to as "research and development," "R&D" or "research and experimentation" credits.

Currently, businesses may claim the research credit on an originally filed return or an amended return. The new requirements apply to the latter, although it's possible that the IRS will attempt to enhance the documentation requirements for originally filed returns down the road.

Overview of the credit

While the research credit and related regulations are complex, in a nutshell, they allow a business to claim a credit for a portion of its *increased* expenses attributable to qualified research activities (QRAs). Generally, QRAs are activities that:

- Are incurred in connection with the taxpayer's trade or business,
- Strive to discover information that's technological in nature,
- Relate to a new or improved business component, such as a product, process, computer software, technique, formula or invention, and
- Are part of a process of experimentation.

Historically, a business claiming the research credit — whether on an originally filed return or an amended return — didn't need to include specific documentation with its filing. Rather, the business was required to "retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit."

New requirements

The new guidance is based on the specificity requirement in the IRS regulations. Under this requirement, a taxpayer claiming a refund must "set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof." Accordingly, for a research credit refund

What’s happening with research expense deductions?

Traditionally, there have been two distinct tax benefits for businesses that conduct research: the research credit and the deduction for research expenses. Previously, businesses had the option of deducting these expenses immediately in the year they’re paid or incurred. But under the Tax Cuts and Jobs Act (TCJA), starting this year, most research expenditures must be capitalized and amortized over at least five years (15 years for research conducted outside the United States).

This requirement will affect not only the deductibility of research expenses but also the value of the research credit. Be aware, however, that legislation pending in Congress would delay the requirement until 2026. Stay tuned.

claim to be valid, a taxpayer must, at a minimum, follow these three steps:

1. Identify all business components to which its research credit claim relates for that year.
2. For each business component, identify all research activities performed, all individuals who performed each research activity and all the information each individual sought to discover.
3. Provide the total qualified employee wage expenses, total qualified supply expenses and total qualified contract research expenses for the claim year (for example, using Form 6765, “Credit for Increasing Research Activities”).

This is a significant departure from previous guidance. Previously, businesses had to retain records to substantiate the research credit, but they weren’t required to include such documentation with their amended returns. Not only does the new guidance place additional burdens on businesses filing refund claims for the research credit, but it also increases the risk that the credit will be denied.

Suppose, for example, that a business files a refund claim shortly before the statute of limitations expires (generally, three years after the original filing or two years after the tax was paid, whichever is later). If the IRS rejects the claim for failure to meet the new documentation requirements, the business will lose the opportunity to refile its claim to supply the missing information.

Temporary relief

The new requirements apply to refund claims postmarked after January 10, 2022. During a one-year transition period that runs through January 9, 2023, the guidance provides some relief for taxpayers that file deficient claims.

These taxpayers will receive a letter from the IRS detailing the missing information and providing them with 45 days to “perfect” the filing. So long as the initial refund claim was filed on a timely basis, a claim that’s perfected within this 45-day period will also be considered timely, even if the statute of limitations has expired.

Get your papers in order

If you plan to file an amended return to claim the research credit, familiarize yourself with the new documentation requirements and be sure you have *all* the information to include with your return. Once the transition period ends, there will be no do-overs. Contact your tax advisor for assistance. ■

Business succession and estate planning go hand-in-hand

If you're a business owner, your company likely is your most valuable asset. Thus, addressing it in your estate plan is critical if, for example, you die unexpectedly or become disabled. Your plan can also help provide a smooth transition of the business to your children or other family members after you retire.

Draft key documents

A comprehensive estate plan should be supported by a core of several key documents. For starters, a basic will divides up your assets, including your business interests, among designated beneficiaries, as well as meeting other objectives. Without a will or having assets otherwise titled, your business and other assets will be distributed under the prevailing laws in your state, regardless of your wishes.

In addition, adopt a power of attorney for someone to manage your affairs in the event you become incapacitated. This "attorney-in-fact" can conduct business transactions. The power of attorney should be complemented by health care directives providing guidance if you can't make medical decisions for yourself.

If you own significant business assets, consider maximizing the federal estate tax breaks currently on the books.

Customize your estate plan to accommodate your business needs. For instance, in some states, a spouse won't be able to access business assets without court approval. To avoid this result, you might place assets in a trust you've established as legal owner.

Use tax breaks to your advantage

If you own significant business assets, consider maximizing the federal estate tax breaks currently on the books. This includes the use of the unlimited marital deduction and the generous federal gift and estate tax exemption. For 2022, the exemption shields assets valued up to $12.06 million.

Be aware that certain states also impose their own state or inheritance tax. Inheritance tax paid by family members, such as your children, comes out of their own pockets — not the estate's.

Fortunately, you can minimize taxes on both the federal and state levels by using multiple trusts or setting up a family limited partnership (FLP). With a tax-favored FLP, the assets are removed from your taxable estate, and limited partner

interests can be gifted to loved ones, often at a discounted value. Finally, be aware of tax consequences for ultimate distributions of retirement plan accounts to designated beneficiaries.

Think about a plan of succession

Many business owners dream of the day they can transfer ownership to their children, who will continue to run the operation when the owner retires. A succession plan can provide a smooth transition of power and be used in the event of an unexpected death of an owner.

Typically, a succession plan will outline the structure of the business going forward and prepare for the eventual sale of the business. Make sure that the plan is memorialized in writing. Identify training opportunities and special compensation arrangements for your successors. One section of the plan should include all the financial details reflecting assets, liabilities and current value. This section may need to be updated periodically, as a business's financial condition and value may change over time.

Coordinate your succession plan document with your will and the other estate planning documents discussed above.

Avoid potential family conflicts

It's not unusual for a family to face internal challenges and struggles as the entrepreneur reaches retirement age. Unfortunately, leaving one sibling out in the cold while another is anointed to run the business can create hard feelings. Or giving someone a secondary role may cause conflicts.

A common estate planning strategy is to attempt to "even things out." For example, say for simplicity that you own a business valued at $5 million and you have $5 million in other assets. You've named one of two children to succeed you as the business owner. In this case, you can give the successor child the $5 million in business assets and leave the remaining $5 million in assets to the other child.

Here's to a smooth transition

There's no universal plan for family business succession. What's right depends on your particular circumstances and goals. But one thing is certain: To ensure that your business survives after you're gone, your estate plan must address the estate tax impact of transferring your ownership interests to the next generation. Your estate planning advisor can help shape a plan to meet your unique circumstances. ■

Are you making the most of your 401(k) plan?

If your employer offers a 401(k) plan, you probably know that one of the best ways to save for retirement is to max out your contributions each year. In 2022, for example, you can defer up to $20,500 in pretax salary to a 401(k) plan ($27,000 if you're 50 or older). And if your employer offers matching contributions, you probably also understand the benefits of contributing at least enough to qualify for the maximum employer match. If you don't, you're leaving free money on the table.

What you may not know is that the timing of your contributions can have an impact on your eligibility for matching contributions. For example, if you "front-load" contributions — that is, max them out early in the year rather than spread

them evenly over the entire year — you risk losing a significant amount of matching contributions, depending on the terms of your plan.

Front-loading advantage

If your plan allows it, front-loading can be a smart investment strategy because the markets generally appreciate in value over time. So, the earlier you contribute to a retirement plan, the more time those funds are in the market, thus creating the possibility of greater returns in the long run.

Of course, when it comes to investing there are no guarantees, and there are times when the markets go down. If you max out your 401(k) contributions by the end of April and the market crashes in June, you may discover that your returns for that year are lower than if you'd spread your contributions over the year.

Despite this risk, people who front-load their contributions tend to enjoy greater long-term returns. But front-loading can backfire — in dramatic fashion — if your employer matches contributions based on your compensation each pay period rather than your annual salary.

Maximizing matching contributions

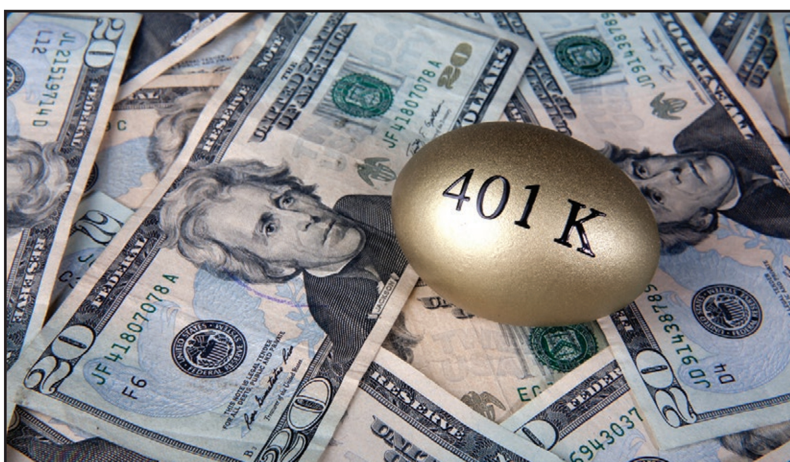
The employer match is a powerful tool for boosting the returns on your 401(k) account. But the method of determining matching contributions can vary significantly from plan to plan. A common approach is to match contributions up to a certain percentage of your compensation for each pay period.

Under this approach, front-loading contributions may cause you to miss out on a substantial amount of free money. Here's an example:

Michelle's salary is $240,000 per year, paid over 24 pay periods ($10,000 per pay period). She front-loads her 401(k) contributions, deferring 20% of her salary, or $2,000 per pay period. Her employer offers dollar-for-dollar matching contributions, up to 5% of income — in this case, $500 — in each pay period.

In 2022, Michelle reaches the $20,500 contribution limit by her 11th paycheck in the middle of June, with matching contributions totaling $5,500. Because Michelle has maxed out her contributions, she stops making contributions in mid-June, and receives no matching contributions for the rest of the year.

Suppose, instead, that Michelle deferred 9% of her salary ($900 per pay period) to the 401(k) plan. In that case, she wouldn't reach the contribution limit until her 23rd paycheck in mid-December, and would receive $11,500 (23 x $500) in matching contributions. That's an additional $6,000 in pretax contributions each year, plus tax-deferred earnings on those amounts. That can give your retirement nest egg a significant boost over 10 or 20 years. In most cases, these additional savings will eclipse the benefits of front-loading contributions.



Know your plan

To make the most of your 401(k) contributions, be sure to understand your plan's terms. If matching contributions are determined for each pay period, then front-loading will likely cost you money. But if your plan allows you to receive a match based on your contributions for the year, then front-loading may provide an advantage. ■

Tax Tips

Get ready for new cryptocurrency reporting requirements

If you own cryptocurrency, such as Bitcoin, or certain other digital assets, be aware that new tax reporting requirements go into effect next year. The new requirements don't affect your tax liability — you're already required to recognize gain or loss on certain transactions involving these assets in much the same way as securities or other capital assets. But starting with the 2023 tax year, digital asset platforms (known as "Crypto Exchanges") will report these transactions to you and the IRS on Form 1099-B.

Review Forms 1099-B carefully and keep documentation of your digital asset transactions. Crypto Exchanges may not have access to the information needed to calculate your tax basis in these assets and, as a result, the forms may overstate your gains or understate your losses. Also, if you use cryptocurrency to pay for goods or services, note that the new rules will require businesses to report transactions of $10,000 or more to the IRS in the same way they currently report cash transactions above that threshold. ■

Buying real estate? Pay attention to purchase price allocations

Rental real estate owners may give little thought to the way the purchase price is allocated between land and building when purchasing or selling property. Some people simply use a rule of thumb, such as the "20/80 rule" (20% of the price is for land, 80% is for the building). But these allocations can have significant tax implications, so it pays to consider them more carefully. For example, the cost of a building can be depreciated, but the cost of the land can't. So, to maximize your tax deductions, it's in your interest to allocate as much of the price as possible to the building.

If you're selling depreciable property, gain attributable to recaptured depreciation is taxable at rates as high as 25%, with the remaining gain taxable at lower capital gains rates. If you're able to allocate most of your gain to the land (for example, because the land's value has appreciated significantly, while the value of the building hasn't), you can minimize the amount of gain taxed at the higher rate. ■

Watch out for employer-provided life insurance

Employers that provide employees with group term life insurance as a benefit may create unexpected — and unwelcome — tax consequences. To the extent the coverage exceeds $50,000, its cost is considered taxable income to the employee and is subject to payroll tax. To avoid these consequences, employers may want to consider limiting group coverage to $50,000 per employee and exploring other options for providing additional coverage, such as allowing employees to purchase supplemental group term life insurance. ■

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