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Re-Engineering Your Documentation Collection Process for the Research Credit

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Introduction

- The Research Credit under section 41 is one of the primary ways in which the federal government uses the tax code to encourage private investment in research and development.
- Taxpayers' research credit claims are a frequent source of contention with IRS examiners.
- According to IRS filing statistics, section 41 was the most common source of uncertain tax positions disclosed on Schedule UTP for the 2013 and 2014 tax years.
- One common issue raised during audits is whether the taxpayer provided adequate documentation to establish that its research activities meet the requirements of section 41.

The Documentation Problem

The Documentation Problem

- IRS examiners often want contemporaneous documentation to prove that the taxpayer engaged in qualifying research.
- Taxpayers preparing to claim the research credit will often have gathered documents from the researchers whose work formed the basis of the claim.
- The collected documents may be voluminous, filling binders that require many shelves to hold.
- Nonetheless, the IRS will frequently conclude that the documentation gathered does not establish that the activity was qualified research.

The Documentation Problem

- Neither the statute itself nor its regulations offer any clarity.
  - A taxpayer must "retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." Treas. Reg. § 1.41-4(d).
- The documents created in the development process do not naturally highlight how the research satisfies the requirements for qualified research.
- The taxpayer engineers often lack sufficient understanding of what documents are useful for tax purposes.
- The IRS examiners often lack an understanding of the development process and are unable to articulate what types of documentation might establish qualified activities.

Agenda

- Understanding your company's research documentation in the context of the product development process.
- Applying your company's research documentation to the requirements of section 41.
- Suggesting documentation strategies for certain types of activities that are commonly challenged by IRS agents.
- Offering approaches to identifying and collecting useful supporting documentation.

Understanding What Documentation is Available

Product Development Process

- Substantial documentation often exists but one must locate and select which portions of that documentation are relevant.
- Important first step is to develop an understanding of your company's research process.
- Use the major phases of the product development process to identify and explain records that support your claims.
  - Many companies have a standardized product development process that describes the research activities involved in bringing a new product concept to market.
  - The product development process can serve as a useful blueprint for the types of research and experimentation activities that produce useful documentation.

Product Development Process

- The Tax Court's opinion in *Suder v. Commissioner*, T.C. Memo. 2014-201, 108 T.C.M. 355, relied heavily on the taxpayer's process of experimentation in holding that the taxpayer properly substantiated its claimed credit.
- Rather than focusing on whether individual activities or cost centers met the requirements of section 41, the Court in *Suder* recognized that the entirety of the taxpayer's systematic development process was the process of experimentation and that each step in that process was a qualified activity.
- Thus it is important for the Exam team to understand that the research process is not found in any particular document; the entirety of the project file is the research process.

Product Development Process

- A standard research process will generally contain the following phases or steps:
  - Concept
  - Planning
  - Design
  - Testing
- Each phase of the product development process will produce certain types of documentation.

The Concept Phase

- During the concept phase, an unmet need is identified and a potential solution is developed.
- Researchers, design engineers, marketing personnel, and upper management are often involved in concept development.
- Early stage scientific research is performed.

The Planning Phase

- At the planning phase, the initial concept requirements are further developed into a more definite set of systems requirements.
- The roles and responsibilities of each function involved in the project are laid out in more detail.
- Project deadlines and financial and human resources required for the project are determined.
- Formal Project Plan is reviewed and approved.

Project Plans

- Project or Development Plans are often the most useful documents in the project file and the most assessable document for the non-engineer.
- Project Plans typically contain the following information:
  - Business objectives
  - Project team description
  - Project schedule and budget information
  - Assumptions and risks associated with project
  - Project deliverables checklist

The Design Phase

- During the design phase, engineers will begin to create a physical realization of the new concept that meets the system requirements.
- Prototypes and pilot units are designed and built.
- The design is evaluated and improved through rigorous testing.
- Manufacturing processes are designed and verified.

The Testing Phase

- The testing and evaluation phase consists of design verification and validation testing, pilot builds, and hazard and safety review procedures.
- The actual test plans and reports are unlikely to be interesting but can demonstrate how the experimentation process resolves uncertainty.

Other Types of Documents

- Organizational Charts
  - Potentially helpful if they list project teams and associated cost centers.
  - May not identify functions that are not traditionally included in dedicated R&D teams.
- Project status meeting minutes or presentations
  - Focus is on what is going well as failures often relate to a lack of project resources as apposed to design uncertainty.
- Testing reports for incoming components and materials from suppliers.

Other Types of Documents

- Patents
  - Issuance of a patent is "conclusive evidence that a taxpayer has discovered information that is technical in nature that is intended to eliminate uncertainty concerning the development or improvement of a business component." Treas. Reg. § 1.41-4(a)(3)(iii).
- Lab Notebooks
  - Often highly technical and difficult to interpret
  - Difficult to copy
- Major phase gate documents
- Attendance sheets for project reviews

Your Company's Documentation

- Who can educate you about how your company conducts research and development?
  - VP Research & Development
    - Senior executives are excellent communicators and are best suited to educating you on the company's process.
    - But time with senior executives is often limited.
  - Alternatively, R&D project leaders or team leaders may be able to guide you through the process.
    - Easier to get access to their time.
    - Lower level personnel may also have more intimate knowledge of documentation practices.

Complying with the Statutory Requirements of Section 41

Statutory Requirements of Section 41

- The expenditures are research and development costs "in the experimental or laboratory sense" (Section 174 test);
- The research must be undertaken to discover technological information (Technological Information Test);
- The research is "intended to be useful in the development of a new or improved business component of the taxpayer" (Business Component Test); and
- "Substantially all" of the research and experimentation activities "constitute elements of a process of experimentation" (Process of Experimentation Test).

Treasury Regulations

- Treas. Reg. § 1.174-2(a): "Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would *eliminate uncertainty* concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product *or the appropriate design of the product*." (Emphasis added).

Treasury Regulations

- Information is technological in nature if the process of experimentation fundamentally relies on the principles of the physical or biological sciences, engineering, or computer science. Treas. Reg. § 1.42-4(a)(4).
- A process of experimentation is a process "designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain . . . ." Treas. Reg. § 1.41-4(a)(5)(i).

Documentation Approaches for Specific Functional Areas

Problem Areas in Exams

- Sometimes the IRS accepts that some qualifying research was performed but disallows QREs claimed for expenditures incurred by particular cost centers.
- IRS Exam teams often target QREs claimed for the following functional areas:
  - Quality and Production
  - Administrative Personnel
  - Marketing

Quality and Production Departments

- Quality and Production groups are often involved with a variety of testing, pilot unit builds, and design reviews.
- Exam teams have a tendency to view quality testing as "routine" activity that does not meet the requirements of section 41.
- Agents fail to appreciate that prototypes and pilot builds often take place at the manufacturing facility and are performed by employees in the manufacturing and production departments.
- Production employees may spend a portion of their time on commercial builds and another portion on pilot units that likely meets the requirements of section 41.

Quality and Production Departments

- Taxpayers should demonstrate to Exam that while these activities may not meet the requirements of section 41 when viewed in isolation, they are critical and necessary to a sound *process of experimentation* that is designed to *eliminate uncertainty* of the appropriate design.
- Project plans may identify which departments or cost centers are responsible for the prototype and pilot builds.
- Project Plans may also provide a description of the types of testing that is performed in the course of the larger development effort.

Quality and Production Departments

- Test plans and protocols are helpful in demonstrating the iterative nature of product development and design testing.
- Plans and protocols to test supplier components are also part of the process of experimentation.
  - Ensures that your test results are reliable by confirming that all materials and components acquired from suppliers meet specifications.

Administrative Personnel

- IRS agents often dispute QREs claimed for employees in management positions, arguing that based on their titles alone they are too far removed from the actual research activities.
- However, managers and executives may be performing direct research themselves or directly supporting R&D teams that are performing the research.

Administrative Personnel

- Surveys may help highlight the role of administrative employees by identifying the cost centers that report to them who are in turn directly involved in performing research.
- Project plans may also demonstrate the importance of the oversight and project management duties performed by higher-level managers.
  - For example, project plans may call for a large number of tests or processes for a particular project, highlighting the fact that R&D teams need administrative personnel to organize and manage the complex project.

Marketing Departments

- Section 41 rejects as qualifying research any activity related to "market research, testing, or development (including advertising or promotions) . . ." IRC § 41(d)(4)(D)(iii).
- As a result, IRS agents often blindly reject QREs claimed for all marketing related cost centers based on department name alone.
- However, taxpayers may succeed in demonstrating that certain marketing groups are involved in the early concept development stage and work closely with R&D teams to identify promising new technologies and product features.

The Document Collection Process: How Do I Capture That Material?

Where are Documents Stored?

- Important to gain an understanding of how documents and data are stored and the retention policy for research materials.
- Determine who manages your company's research documentation.
  - Companies subject to FDA regulation are subject to design controls that may dictate how and when records are kept.
  - Software companies often have depositories of the various parts of the software program.

Where are Documents Stored?

- Documents themselves are often informative regarding where and how records are kept:
  - Documents may indicate storage location.
  - Documents may include provisions explaining record keeping.
  - Documents often have a numbering convention tied to recording keeping.

The Initial Collection

- Some documentation is important to collect and analyze at the outset while other more detailed research documentation can be left for later collection.
- The initial collection might target the following:
  - Standard Operating Procedure for R&D process
  - R&D Project Plans
- These documents will provide an overview of the company's process and identify the types of supporting documentation that might exist.

Initial Collection: Project Plans

- While it is often unnecessary to collect all research documentation, we suggest a comprehensive collection of all available Project Plans.
- Project Plans are helpful in several ways:
  - Provides a high-level description of the research project that is accessible to non-engineers.
  - Shows involvement by many different functional groups.
  - Often describes uncertainties or risks involved in development of new product.

Providing Example Documentation

- Providing representative examples may be an effective way to support your research credit claims without producing *every* research document in the project files.
- Important to have sample documents in the audit file to demonstrate to Appeals your good faith effort at providing responsive documentation.

Providing Example Documentation

- Start by collecting a complete set of documents that illustrates the product development process from start to finish for one project.
- Walk through the documents in this initial set with the exam agent to explain how each type of document fits into the process as a whole.
- Make clear that the documents in this initial set are merely representative of the company's research documentation.
- Be prepared to articulate why the related activity meets the requirements of section 41.

Providing Example Documentation

- For each type of document that was collected as part of the initial set, attempt to find similar documents for other R&D projects.
  - For example, if you provided hardware engineering functional plans and electrical testing plans as part of the initial set, collect the same type of documents for other development projects.

Conclusion

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- Understand your company's research process.
- Use major phases of the research process as a framework for locating key documents.
- Engage in a comprehensive collection of major documents (e.g. product development process model; project plans).
- Identify where you might find additional example documents.
- Fill in gaps for challenging functions such as administrative and manufacturing departments.
- Be prepared to explain how documents relate to the statutory requirements.

Conclusion

- Even with excellent record keeping, research documentation will probably not substantiate every expenditure claimed.
  - Some activities are less likely to generate useful documents (e.g. manufacturing).
  - Even useful documentation will not clearly indicate the percentage of time devoted to the activity.
- Cost centers that spend smaller percentage of time on qualifying research are less likely to have helpful documentation.
- Given these limitations, it is important to understand what your agent's main issues are and focus on answering them.