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# Sustaining Your Research Credit Cost Allocations:

*Making the Most of What You Have*

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# 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 costs are “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).

# Introduction

- Sustaining research credit claims requires taxpayers to not only establish that their research activities meet the requirements of section 41, but also to reasonably allocate research expenses to qualifying activities.
- Allocating costs to qualified research is often a significant challenge for taxpayers and has been a major issue in litigated cases.

\* *Other presentations on the research credit prepared by William Schmalzl and Michael Kaupa can be found at our bio pages on Mayer Brown's website.*

# The Problem

- Most taxpayers do not have a system to track costs to specific research activities.
- Taxpayers are unable to rely on their general accounting system because the requirements for financial reporting are often at odds with the requirements of section 41.
  - Expenses that are not research expenses for financial accounting purposes may fall within the scope of the research credit for tax purposes.
  - Conversely, even where a cost center clearly performs research activities, portions of its costs may fail the requirements of the credit.

# The Problem

- While taxpayers employ a variety of methods to estimate and allocate research expenses in calculating their research credit, some common approaches exist.
- This presentation will discuss these approaches and offer suggestions for getting the most out of your company's system.

# Legislative History and Case Law

# Legislative History and Case Law

- Neither the statute nor the regulations under section 41 specify how costs should be allocated to qualifying research.
- Taxpayers thus have flexibility in devising an approach to allocating costs for purposes of the research credit.
- Fortunately, case law instructs that taxpayers are not required to have a perfect cost allocation system to sustain their credit.

# The *Cohan* Rule

- Nevertheless, at a minimum, taxpayers must first establish that employees are actually performing qualified research.
  - A line of cases starting with the Second Circuit’s decision in *Cohan v. Commissioner*, 39 F. 2d 540 (2nd Cir. 1930) holds that if a taxpayer proves it is entitled to a tax benefit but does not adequately substantiate the *amount* of that benefit, the court may make an estimate based on the available evidence, “bearing heavily if it chooses upon the taxpayer . . . .”
  - Frequently referred to as the “*Cohan* Rule”, the holding in *Cohan* emphasizes the primary importance of establishing a reasonable basis for the court to determine that the taxpayer’s employees did in fact perform qualified research; only then will the court estimate the taxpayer’s QREs.



# Common Approaches to Wage Allocations

# Explore Your Cost Allocation System

- The first step in maximizing your credit is to understand what system your organization already has in place and how research costs are tracked.
- While project plans often contain budgeted costs for research and development efforts, the data supporting the estimates is frequently unavailable when the taxpayer defends its research credit claims in audit.
- Nevertheless, it is always advisable to discuss with R&D management how they track these estimates.
  - Even if the R&D department's accounting system does not capture everything, it could still serve as a useful base level for your credit claim.

# Common Approaches

- In general, taxpayers employ two types of wage allocation systems:
  - **Employee Interviews/Surveys:** process by which R&D employees (often managers) explain, after the close of the tax year, the nature of their department's work and estimate the amount of time spent on qualifying research.
  - **Time Recording Systems:** systems that record employees' time on particular projects and/or specific research activities.

# Employee Surveys

- Likely the most common method for allocating research costs.
- Generally involves interviews with managers after the close of the tax year to gather information about the nature of employees' research activities and the percentage of their employees' time spent on qualifying research.

# *Suder v. Commissioner*

- Use of surveys was accepted by the Tax Court in *Suder v. Commissioner*, T.C. Memo. 2014-201.
- The facts of *Suder* render its holding somewhat limited:
  - Small company with roughly 125 total employees and 40 engineers
  - Study was conducted by Senior Vice President of Product Development who had intimate knowledge of the taxpayer’s research activities.
  - Exhaustive testimony which included three week trial session, “more than 3,500 pages of testimony and . . . more than 170,000 pages of exhibits.” *Id.* at \*5.
  - Costly loss on issue of reasonableness of Chief Executive’s wages.

# Implementing a Survey System

- The interview or survey should be completed by department or cost center managers as close to the end of year as possible.
- Survey or interview questions often include:
  - Description of the department's general function.
  - Description of the department's significant R&D activities.
  - Description of the technical or design uncertainties.
  - Description of the alternatives or hypotheses evaluated
  - Description of the business component being developed
  - Whether the department provided direct support to R&D
  - Percentage of employees' time spent on qualifying research.
  - Whether the department developed internal use software.

# Other Benefits of Surveys

- Surveys may capture a variety of useful information beyond the percentage of time spent on qualifying activities.
  - Survey responses may provide helpful detail on the activities of each research cost center.
  - Surveys often ask respondents to attach any relevant project documents.
- Cost center managers are able to describe the activities and function of the department as a whole without having to interview every single employee in the R&D department.
  - If dispute over your credit is litigated, managers would be able to testify based on their personal knowledge of the cost centers which they oversee. *See, e.g., Suder.*

# Training

- Survey takers will typically need to be educated on the requirements of section 41.
- Exam teams will often explore whether interviewees and survey takers have a basic understanding of the law.
  - Education should be balanced enough to demonstrate that employees are able to identify non-qualified activities.
- In addition to establishing that survey takers have a baseline education of the credit, taxpayers should document how the responders are familiar with the cost centers' activities.
  - Be mindful of practical limitations; it is probably unreasonable to expect one manager to have a working knowledge of the activities of 100 or more subordinates.



# Surveys: Precision of Time Allocation

- Some survey respondents use highly individualized percentages while others use larger percentage buckets (e.g. 0%, 25%, 75%, 100%).
- The use of percentage buckets is very common.
  - While it offers less precision, it is still defensible and arguably easier to defend.
- Whether it is preferable to use large buckets or allow respondents to freely choose wage percentages may depend on the individual preferences of your Agent or Appeals officer.
  - Some agents may exploit even small inconsistencies to argue that the percentages are inaccurate or arbitrarily assigned.
  - Conversely, agents or Appeals officers may be impressed with more narrowly tailored percentages even if there are inconsistencies among research employees.

# Time Recording Systems

- Time records are used for financial accounting purposes as well as tax compliance.
- The tax department will likely not be able to impose a time recording system on the company as a whole if one does not already exist.
- However, the tax department might make a case for certain modifications to an existing system that capture tax-specific information.
- Having non-tax purposes for establishing the time recording system enhances the reliability of the data.

# Time Recording Systems

- Taxpayers employ a variety of different time recording systems that capture varying amounts of detail.
- Some of the most common time recording systems include:
  - Systems that capture time spent on a particular project (“Project Level Time Records”).
  - Systems that capture time spent on a specific type of activity (“Activity Level Time Records”).
  - Systems that capture time spent on particular projects and the specific type of tasks performed within each project (“Detailed Time Records”).

# Project-Level Time Records

- Some time systems only track time that employees spend on a particular project or development effort.
- This approach has the benefit of simplicity: engineers spend less time recording specific tasks.
  - Also less opportunity for inconsistent or inaccurate recording.
- However, because this system ignores the particular *activity* of each employee, Exam agents may argue that these records fail to adequately substantiate the amount of time allocated to qualified research.

# Strategies for Filling the Gaps: Project Level Systems

- Even if your system only records time spent on particular projects, this information is still useful.
- Maximize the value of project-level cost data by collecting project plans and other documentation that illustrate the company's significant research and development activities.
  - Even if information on specific activities is missing, it should be clear from project records that engineers who charged significant amounts of time to a new product design devoted a large percentage of his or her time to qualifying research.
- Educating the Exam team on the company's research process and how the various parts of the organization fit into that process will make project documentation more persuasive.

# Activity Level Time Records

- Systems that only record particular activities raise the opposite challenge, i.e., missing information about the particular project or business component being developed.
- For example, the IRS may argue that it is impossible to have a complete understanding of employees' research activities if they are unable to match tasks with particular projects.
  - Project information may be important if employees are involved with multiple different projects at various stages of the development cycle.

# Strategies for Filling the Gaps: Activity Level Systems

- It may be possible to modify your system to capture project information.
  - If the system already asks employees to record their research activities, adding a project field should be manageable.
- Depending on the nature of your company's research activities, project information may not be all that meaningful.
  - If an engineer devotes substantial time to the same research task, determining which projects he or she worked on likely does not change the fact that his or her wages are qualified.
  - If your company undertakes a small number of projects throughout the year, it may not be necessary to track research activities by project.

# Detailed Time Records

- Detailed time records typically contain the following:
  - Number of hours spent on a particular project, product feature, or system.
  - Number of hours spent on a specific type of activity within each project (e.g. design modeling, software tests, building prototypes)
- Ideally, system should track non-qualified activities as well, such as attending training seminars, general management tasks, or vacation time.
  - IRS may challenge the system as unreliable if the employees cannot identify non-qualified activities.
  - Example: production employees who split time between building prototypes and routine production builds.



# IRS Challenges to Detailed Time Records

- Despite the high level of detail, the IRS may still challenge the reliability of the system, for example:
  - Inquiring whether and how research employees were monitored when completing their time records.
  - Scrutinizing the extent to which employees are able to record non-qualified activities in addition to qualified activities.
  - Selecting a representative sample of time records and seeking interviews with employees regarding the activities he or she performed.

# Addressing Audit Concerns

- Be prepared to push back against efforts to audit the system.
- Articulate for Exam agents that the value of such a system is that the records are *contemporaneous*.
  - Audits take place years after employees completed their time records and employees should not be expected to have full recollection of what they did on a particular day.
  - Employees who are involved with multiple research projects over the course of the year will have a particularly hard time recalling when specific tasks were completed.
- Point to evidence that the system is working appropriately.
  - If some employee records show significant amounts of non-qualified activities, emphasize that such evidence is proof that the system is appropriately *excluding* non-qualified activity.

# Addressing Audit Concerns

- Exam agents may request to sample time records to evaluate the accuracy and consistency of your system.
- Approach proposals to use sampling cautiously.
  - Determining the accuracy of any particular time entry is likely futile given the length of time that will have passed.
  - Determining how many samples are required for the sample to be statistically significant will be difficult.
  - What matters is that the taxpayer has a valid system in place and that the system is consistently followed.

# Considerations for Vulnerable Areas

- Regardless of the particular allocation method used, taxpayers should seek contemporaneous documentation providing additional support for certain vulnerable areas.
  - **High Ranking Employees.** Consider requesting these employees to prepare a memorandum explaining their role.
  - **Research Managers.** The research process itself needs to be managed. Consider project plans or other documents that show how managers provided support of qualifying research.
  - **High Dollar Cost Centers.** Look for project plans or project status meetings that identify the employees or cost centers involved.
  - **Cost Centers Performing Substantial Non-Qualified Activity.** Planning documents or attendance logs at project meetings will help provide indirect support.

# Accounting for Supplies and Contract Research

# Supplies

- Qualified research expenses include “any amount paid or incurred for supplies used in the conduct of qualified research.” I.R.C. § 41(b)(2)(A).
- Supplies are typically allocated proportionately in accordance with qualified research activity.
  - I.e., cost centers with a higher percentage of qualified research activity will receive a correspondingly higher percentage of research supply costs.
- Taxpayers should consider asking about the use of materials, equipment, and other supplies during interviews with cost center managers to determine if allocation of supplies based on qualified research is appropriate.

# Issues with Accounting for Supplies

- Supplies used during the commercial production process.
  - If research is being performed on the production process (as apposed to the product itself), supplies that are used or consumed during the commercial production of goods and that would have been purchased regardless of the qualified research are not QREs. *See Union Carbide Corp. & Subs v. Comm’r*, T.C. Memo 2009-50.
- Depreciable property.
  - Costs used to design and build tools or equipment to be used in producing commercial products are not QREs because they are costs to acquire or improve property of a character subject to depreciation. *See TG Missouri v. Comm’r*, 133 T.C. 278 (2009).

# Issues with Accounting for Supplies

- Self-constructed supplies.
  - Depreciation, overhead, and other general and administrative expenses that relate to “self-constructed” supplies are not qualified research expenditures. *See* FSA 200219001 (May 10, 2002).
  - IRS concluded that only supplies that are used in the conduct of qualified research are included in the credit calculation.
    - Depreciation, overhead, and other general and administrative expenses are *indirect* expenses.
  - The IRS rejected arguments from taxpayers that had they instead purchased the supplies from a third party, the cost of overhead would be baked into the purchase price.



# Contract Research

- Qualified research expenses include contract research expenses, which are defined as amounts “paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research.” I.R.C. § 41(d)(2).
- From a cost allocation standpoint, the advantage to contract research is that taxpayers are able to document the amount of the expenditure for a particular research task up front.
  - Reduces likelihood that Exam will challenge the amount of the expenditure allocated to the project.

# Contract Research

- Contract research generally falls into 2 categories:
  - Outsourcing an entire research project
    - Outsourcing design for entire product
  - Hiring contract labor
    - SAP implementation
    - Software development contractors
    - One-off, targeted research efforts
- When hiring contract labor, identifying and documenting the specific activities performed by each contractor is more challenging.
- Be wary of contract research conducted outside of the U.S.
  - Be sure to document *where* work was done.

# Documenting Contract Research

- Taxpayers should ensure that contractual documents make clear who owns the rights to the finished product and who assumes the risk.
  - Under Treas. Reg. § 1.41-2(d)(2), the agreement must:
    - Be entered into prior to the performance of the qualified research;
    - Provide that research be performed on behalf of the taxpayer; and
    - Require that the taxpayer bear the expense even if the research is not successful.
  - Regulations add that “[i]f an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research then the expense is considered paid for the product or result rather than the performance of the research.” *Id.*

# Conclusion

- Employee surveys are a defensible cost allocation method.
  - Employees who complete the surveys should have an understanding of the research credit and personal knowledge of the activities performed by research employees.
- Contemporaneous time records, if available, are advantageous.
  - But even detailed time records can be challenged by the IRS.
  - Taxpayers should investigate ways to improve the information captured by their time recording system.
- Research project documents are often helpful in supporting employee surveys or time records.

# Conclusion Cont'd

- Supplies is an often overlooked area that can result in substantial adjustments.
  - Taxpayers should carefully evaluate whether their supply costs are being allocated appropriately.
- Appropriate documentation of contract research is critical in supporting those costs for the credit.
  - Important to capture *what* the contractors are doing, *where* they are doing it, and *who* owns the rights to the research.