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# A Tax Controversy Approach to Preparing §41 Research & Development Credit Claims

## Strategies and Considerations When Planning to Make a Claim for R&D Credits


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# Structure of Presentations

- Today we will primarily focus on the basics of the credit and factors to consider as you document your claim to the credit.
- The presentation will focus on issues that arise in proving that your claim meets the legal requirements and how you can try to address these issues as you put your claim together.
- In early January 2010, we will have another presentation that will deal in more depth with specific audit and appeals issues and recent court decisions.

# Business Research vs. Tax Credit

- Recognize that what your business sees as research will not automatically be seen as qualifying for the credit.
- The IRS focuses on the language of the statue and regulations and that language is not the language most business naturally used to describe what they do.
- Goal today is to help you become better at taking your facts and presenting them in a way that bridges business reality with IRS expectations.

# Skepticism Regarding Qualified Research

- Some taxpayers believe that it is easy to claim research credit, but the IRS does not think so.
- In practice, IRS views the scope of credit narrowly.
- IRS is very concerned that taxpayers are claiming the research credit for expenses that do not qualify under IRC § 41.
- Research credit claims were designated a Tier I audit issue in 2007.
- The issue tiering strategy is designed "to ensure that high-risk compliance issues are properly addressed and treated consistently."

# IRS View

- In designating the research credit as a Tier I audit issue, the IRS posited its concerns that these claims
  - “are based on marketed tax products. . . on a contingent fee basis,”
- and suffer from,
  - “high-level estimates,
  - biased judgment samples,
  - lack of nexus between the business component and qualified research expenses (QREs), and
  - inadequate contemporaneous documentation.”

# Taxpayer's Dilemma

- IRS clearly regards claims prepared by third parties with suspicion.
- The IRS laments the growing presence of outside parties' "pre-packaged claims" that "frequently fail to substantiate that the taxpayer paid or incurred qualified research expenses as claimed."
- However, taxpayers often lack sufficient internal resources to gather the necessary information without help from outside parties.

# Focus Studies on Your Specific Facts

- Outside advisors can bring technical expertise and established procedures.
- But your knowledge of your company is also key.
- Be sensitive to details such as the following:
  – Has third-party adapted its methodology to fit with the culture/details of the taxpayer's organization?
  – Use terms that reflect taxpayer's business terminology.
  – Educate business people of the importance of their working with the outside advisors so that the company can obtain the credit to which it is entitled.

# When to File a Claim for Research Credit

- Taxpayers frequently have studies conducted by outside third parties that are prepared after returns are filed and cover a number of years.
- While that approach may at times be necessary and more cost effective, in general, such studies are less persuasive than ones done currently.
  - As noted the IRS sees these refund claims as a "prepackaged product."
  - Finding good documentation only gets more difficult with the passage of time.
- IRS Notice 2008-39 no longer permits taxpayers to claim credits for years under audit during the audit. All claims must now be submitted in advance of the audit (via an amended return) to the IRS Service Center in Ogden Utah.

# §41 Tax Credit is Incremental

- Section 41 applies only to those expenses that constitute an increase on prior expenses.
- Magnifies the impact of adjustments to the amount of expenditures claims as eligible for the credit.
  - The incremental nature of the credit results in the percentage of disallowed credit being much greater than the percentage of disallowed expenditures.

# Fixed Base Percentage and Base Amount

- The incremental research expenditures in the tax year are determined based on Fixed Base Percentage and Base Amount.
- Groups of Corporations – IRC §41(f)(1)(A)
  - When you have subsidiaries, their research expenses must be pooled for the purposes of calculating the credit, and then the credit apportioned according the proportion of research expenses incurred by the subsidiary.
- Mergers & Acquisitions – IRC §41(f)(3)(A)
  - The acquisition of a company entitled to credits can introduce complications. Both the credit and gross receipts of the taxpayer are increased by the amount attributable to the acquired company.

# Consistency Requirement

- Consistency Requirement – IRC §41(c)(6)(A)
  - For the basic credit, the IRS requires that the base amount and fixed base percentage in the base years be calculated in the same manner as the expenses in the taxable year.
  - This means that new base amounts and fixed base percentages are required, when there is a change in identifying eligible expense or an acquisition or disposition.
  - The practical problems of finding needed information with respect to the base period may prevent you receiving the credit on qualified expenditures that had not previously been identified as such.

# §41 Tax Credit
# The Alternative Simplified Credit – IRC §41(c)(5)

- The Alternative Simplified Credit provides a tax credit without the base-period calculation and consistency requirements of the basic credit.
  - While the percentage of the simplified credit is lower than the basic credit (14% vs. 20%) it could result in a greater overall savings depending on the particular spending patterns of the taxpayer.
  - ASC Calc v. Regular Calc.

    = Reg. Calc [(Fixed Base Percentage X Average Gross Receipts for 4 years prior to claim year)] (QRE for claim year) – (but QRE for claim year cannot be more than twice base amount X 20% =

  - ASC Calc = At Taxpayer's Election.

    14% - [QRE for Claim Year – (.5 X Average QRE of prior 3 years)] (12% for years ending before 1/1/09).

# What are Qualified Research Activities According to the IRS

- Expenditures connected with research must be section 174 expenses.
- Must be undertaken for the purpose of discovering information that is technological in nature.
- The taxpayer must expect the discovered information will be useful in development of a new or improved business component.
- Substantially all of the research activities must constitute a process of experimentation.

# Interaction Between the §41 Tax Credit, the §174 Deduction and the §280C Election

- A taxpayer can have both the section 41 credit and the section 174 deduction.
- However, the credited amount must reduce the section 174 amount, if the taxpayer chooses not to make a section 280C election that allows taxpayer to claim a smaller credit in lieu of the add-back.
- Taxpayers need to file a 280C election with their tax returns.
  - This is another reason why it is advantageous to complete one's credit analysis before the tax return is filed.

# §41 Tax Credit *versus* §174 Deduction

- Section 174 applies to research or experimental expenditures intended to eliminate uncertainty concerning the development or improvement of a product or process.
- One can be confident that an appropriate design will be found as long as one is uncertain about  what that design is.
- Section 174 explicitly excludes certain expenses such as ordinary quality control, management studies, consumer surveys, etc.
- While all Qualified Research Expenses creditable under section 41 are deductible under section 174, not all section 174 deductions are creditable under section 41.

# Discovering Technological Information

- The regulations are now clear that this requirement focuses on whether the particular taxpayer already possesses the needed technological information.
- In the past, the IRS considered whether the requirement required the discovery of information not known by skilled professionals in the field.
- While the regulation took the more favorable taxpayer view, that result has somewhat been undercut by the IRS interpretation of the process of experimentation requirement.

# Process Of Experimentation

- The “Process of Experimentation” is a key requirement of qualified research.  It contains three steps:
  1. The identification of uncertainty concerning the development or improvement of a business component;
  2. The identification of one or more alternatives intended to eliminate that uncertainty; and
  3. The identification and the conduct of a process of evaluating the alternatives.
- Establishing that your activities meet these requirement can be surprising difficult.

# Establishing that Activities are Qualified Research

- IRS prefers contemporaneous documentation, because it believes it is more reliable.
- However, such documentation is unlikely to describe the activity in the same terms that the tax law uses in defining the credit.
  - You are unlikely to find the document labeled "Process of Experimentation for Development of Product X."

# Establishing that Activities are Qualified Research *(cont.)*

- Be prepared for the fact that documentation that is created in the course of a company's business often emphasizes the positive rather than the uncertainties.
  - For example, documentation may indicate that the company engineers were "certain" that they would be able to get a return on investment if the company invested in their proposed research project.
  - While the project most likely had uncertainty in design, methodology or technology, that is so obvious that it rarely gets recorded explicitly.
  - Taxpayers should ensure that they can explain how the contemporaneous documentation actually establishes uncertainty during the course of development.

# Establishing that Activities are Qualified Research *(cont.)*

- Do not assume IRS agents will have sufficient experience or inclination to make inferences from the contemporaneous documentation to reach the legal requirements.
  - Documents describing a new product as cutting edge or innovative will not automatically lead to the conclusion that the taxpayer had to overcome technical uncertainties in reaching these innovations.
- To the extent possible, you want to be explicit about how the information you provide relates to the legal standards for the credit.

# CLE Code

# Be Persistent and Proactive in Searching for Documentation

- Finding documentation, test data, summaries and other helpful information takes time.
- However, it is desirable to spend that time at the outset, rather than trying to put it together later.
- Once the agent concludes that your activity does not qualify, changing his/her mind can be difficult.
- Further, once made, getting a case manager or appeals officer to reverse is difficult because they are reluctant to dig into intensely factual areas.

# Be Persistent and Proactive in Searching for Documentation *(cont.)*

- Researchers do not immediately know what will help the company and therefore are unlikely to volunteer useful sources of documentation without probing from you.
  - Many engineers maintain research notebooks even if not required as a matter of policy.
  - Results of tests are often maintained in hard copy or electronic form.
  - IP departments may have procedures for identifying when work on potentially patentable ideas began, which can be well before a patent application is found.
  - Records may also be kept of trade secrets that are never submitted for patents.

# How to Show Research Has a Process of Experimentation

- Taxpayer should connect documentation to the legal standard.
- Obviously want to examine departments that are clearly identified as doing research, although some of the individuals might not consistently be engaged in research.
  - "Qualified wages" include actual research, active supervision of research, support if research, and the development of processes as well as the development of components.
- Some departments might always support research.
- Other departments might be dedicated to non-research activities, but will occasionally contribute to the research effort.
- The taxpayer must demonstrate how each of the qualified employees within these departments contribute to the process of experimentation.

# Tension with Accounting Standards for Research

- In many cases, the definition of qualified expenditures under Section 41 will lead you to include expenses that have not been included as research for financial accounting purposes.
- In general, one should not be surprised to find the different definitions for tax and accounting purposes lead to different characterizations of expenses.
- However, some companies' definition of research for accounting is very similar to Section 41 but in practice have not included all the costs that they concluded are eligible under Section 41. Anticipate how to explain the divergent treatment.

# Activities That Are Excluded from the Research Credit

- Even if a project contains qualified research activities, some of the related activities may not be qualified if they are excluded under IRC § 41(d)(4):
  - Research after commercial production.
  - Adaptation to meet a specific customer's needs.
  - Duplication or reverse engineering of already existing component.
  - Surveys or studies relating to efficiency, management, market research, routine data collection or routine testing.
  - Foreign research outside the territorial limits of the United States.
  - Funded research.
    - The taxpayer must retain the risk of failure.
    - The taxpayer must retain substantial, although not necessarily exclusive, intellectual rights in the outcome of the research.

# The Development of Internal Use Software is Also Excluded, Except in To the Extent Permitted in the Regulations

- The most recent set of regulations have "reserved" treatment of Internal Use Software development costs.
- In addition to the normal section 41 requirements, prior regulations require that development of Internal Use Software meet the following requirements to qualify:
  - The software can be used in a production process that meets normal section 41 requirements; <u>or</u> it must be:
    - <u>Innovative</u>, so results in a reduction in cost, or improvement of speed, that is substantial and economically significant;
    - Subject to <u>Significant Economic Risk</u>, where substantial resources are committed and there is substantial uncertainty that they will be recovered within a reasonable period; and
    - <u>Not Commercially Available</u>, so taxpayer cannot purchase, lease, or license software without modifications that would satisfy the requirements of innovation and economic risk.

# Documenting Amount of Qualified Expenses for Qualified Projects

- Once one establishes what research was done, one still needs to determine the dollar value of expenses related to that research.
- There are three general methods:
  - Project Tracking – This is the IRS's favorite method because the expenses are related directly to their purpose.
  - Cost Centers – These often do not reliably establish the nexus because they do not connect expenses with their business purpose.
  - Hybrid Approach – This is used when mixed record sets can support neither a cost center analysis nor a project tracking analysis.

# Examples of Documentation for Costs

- When preparing documents, the taxpayer should be as detailed-oriented as possible and use as much company-generated (and ordinary-course-of-business) documentation as possible.
- Time cards and other project-specific documentation.
- Annual employee reviews are unlikely to have sufficient detail, but the IRS often wants to look at such reviews.
- Demonstrating that an employee worked on a qualified research project is only one threshold; you still need to show a process of experimentation.

# Documenting the Amount of Expense Associated with the Qualified Research

- Keep in mind you are trying to establish both:
  - The costs associated with the qualified activities and
  - The specific activities performed
- Records showing time employees charge to specific projects generally establish the first point but may level the second open to challenge.
- Systems that require employees to account for their time both by project and the activity done provide the most information but they are relatively uncommon.

# Documenting the Amount of Expense Associated with the Qualified Research *(cont.)*

- Companies may ask a supervisor to make an allocation of employees' time between qualified and non-qualified activities, but this allocation is less credible if presented without contemporaneous circumstantial evidence.
- Such allocations are easiest to defend if the employee is in a department that does substantially all qualified research.
  - Likely that a entry level design engineer in a research department is doing virtually all qualifies activities.
  - Determining how technician in a testing department divided time between products under development and existing products is harder.

# Documenting the Amount of Expense Associated with the Qualified Research *(cont.)*

- Doing such allocations as close as possible to the time the work was done makes the study more convincing.
- Document the allocations with as much detail a possible.
- Keep in mind that the IRS will almost certainly want to interview some or all of the people who made these allocations.

# Qualified Research Expenses – Supplies and Other Equipment

- Property that is depreciated in the hands of the taxpayer is not a supply.
- The purchase of a finished research product is not qualified.
- The purchase of testing equipment is not qualified.
- Frequently, the accounting systems do not provide sufficient options for charging costs, and as a result the supply account includes numerous expenses that are not eligible for the credit.

# Qualified Research Expenses – Contract Expenses

- Contracts for projects often contain a description which helps to establish the qualified nature of the project.
  - However, contract expenses also include temporary employees whose specific tasks may be hard to identify.
- Frequent issues involve who bears the risk of unsuccessful research.
  - Taxpayer not entitled to refund of fixed fee but contract has to continue work on the project at no additional cost.
  - Contract provides for milestone payments as particular targets are met.
- Payments to terminate unsuccessful research project.

# Estimation of Expenses Will Get Resistance from IRS

- In preparing a claim, taxpayers may estimate some costs. However, while some courts have tolerated this under the *Cohan* principle, the IRS is very demanding.
  - Sampling – The IRS has a specific guide for Computer Audit Specialists and Examiners, and may use sampling to try to verify a claim. However, sampling is generally not taxpayer-driven.
  - Extrapolation – Assumes what the relationship between expenses and research is. The IRS will surely ask you to identify this portion of your claim in audit. Unless you can support such assumptions with additional documentation, any extrapolation is likely to meet with intense scrutiny.
- The IRS is highly skeptical of basing a claim on these methods, even if they have been upheld to a degree by courts.

# New Developments Under Obama

- There are three current proposed changes to the R&D tax credit:
  - President Obama proposes to make the tax credit permanent (as opposed to its current dependence on annual renewal) as an offset against the repeal of the Foreign Tax Credit.
  - The Senate Committee on Finance (led by Senator Baucus) has proposed a set of improvements and simplifications - S. 1203, 111th Cong. (2009).
    - The Bill was originally proposed in June, but the Senators have also publicly reiterated their support for this bill as of last week in light of the GAO November Report.
  - The USA Jobs Act, introduced in the Senate, would augment the credit with a bonus percentage of up to 10% for manufacturers who conduct business primarily in the United States - S. 1021, 111th Cong. (2009).

# The Senate Committee on Finance Proposal

- The committee seeks to eliminate base amount considerations and fix the credit at 20% of any qualified research expenses that exceed 50% of the average annual qualified research expenses from the three years prior to the year in question.
- If a taxpayer lacks any qualified research expenses in any of the preceding years, their credit would be equal to 10% of the qualified research expenses in the year in question.
- This is similar to the Alternative Simplified Credit, but offers a larger tax benefit.
- The credit will be made permanent.

# Conclusion

- One can't assume that the IRS will recognize  what your company does will meet the requirement for the credit.
- In the past, the IRS has been plagued by what it sees as unsupported claims.
- The IRS will not easily accept R&D Credit claims.  Expect vigorous audits.
- You need to proactively determine how your company tracks research both in terms of the amount expended and the efforts to develop a successful business component.
- You must carefully control each interaction with the IRS.

# Conclusion *(cont.)*

- Your goal is to make it as hard as possible for the agent to reduce your claimed credit.
- While you can obtain relief from an agent’s erroneous interpretation either with the IRS Appeals Office or through litigation, it is much more effective—in terms of both cost and result-- if you can avoid the agent ever writing that erroneous report.
- Mayer Brown can enhance your credibility by helping to design a process that guides the collection of research expense documentation in a way that harmonizes IRS and Client resources and demands.

# Questions & Answers

*Thank you*

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