Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) - Research Credit Issues

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* Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations.

NOTE: This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

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10. RESEARCH CREDIT ISSUES

a. Coordinated Issues

Currently, there are four research credit Coordinated Issue Papers (“CIPs”), available on IRS.GOV.

(1). Technical writers and other individuals who prepared end user manuals or other instructive documents for the end user.

ISSUE: Whether the wages paid to technical writers, editors, illustrators, and others who assist in the preparation of user manuals, constitute a qualified research expense for purposes of computing the research credit under section 41.

(2). Payments to a deferred compensation plan or trust such as a section 401(k) plan and matching employer’s contributions.

ISSUE: Whether contributions to a deferred compensation plan arrangement under section 401(k) on behalf of an employee who engages in qualified research are qualified research expenses under section 41(b).

(3). Internal-Use Software.

ISSUE: Are “X's” activities related to the installation, customization, enhancement and maintenance of a vendor-supplied software package excluded from the definition of "qualified research" within the meaning of section 41(d)(1) because they fail to satisfy the 3-part exception to the exclusion for internal use software contained in the Conference Report to the Tax Reform Act of 1986 (the 1986 Act)?

(4). Self-Constructed Assets

ISSUE: This Paper addresses whether amounts paid or incurred as depreciation expenses, general and administrative expenses, employee benefit expenses, travel and entertainment expenses, and overhead and other indirect expenses that relate to "self-constructed supplies" are qualified research expenses as defined in section 41(b).

b. Awareness Issues

(1) Wage or qualified service issues.

Common wages issues that are usually found not to qualify for the credit:

- Direct support : in-house attorney- legal fees and patent expenses, secretary expenses
- Direct supervision: above first-line manager

(2) Common supplies issues:

Prototype expenses. Carefully scrutinize "prototype" expenditures to determine whether the "prototype" and/or its subcomponents are property of a character subject to an allowance for depreciation. See Treas. Reg. § 1.174-2. Note that the word “prototype” does not appear in the relevant provisions of either the Internal Revenue Code or the Treasury Regulations; thus, using this label is not controlling.

Extraordinary Utilities. As a general rule, utilities are not QREs. Treas. Reg. § 1.41-2(b)(2)(i). However, a taxpayer may claim extraordinary utilities as QREs. The taxpayer must establish the extraordinary nature of the utility expense. Treas. Reg. § 1.41-2(b)(2)(ii). Merely comparing the square footage electricity use in an administrative building with a research facility is insufficient.

(3) Computational Issues:

Section 280C. If a taxpayer claims the research credit for qualified research expenses (“QREs”), no deduction is allowed for that portion otherwise allowed as a deduction in an amount equal to the amount of the research credit. Section 280C(c)(3). The election of a reduced research credit under section 280C(c)(3) is required to be made with the filing of a taxpayer’s original return.

Tax Consequences of Reversing an Invalid Section 280C(c) Election: There are numerous material federal income tax consequences that may flow from a taxpayer’s recomputation of the research credit at the regular 20 percent rate, with a correlative reduction in its deductions. Some of these potential consequences are: Increased regular or corporate AMT tax liabilities, restricted interest, adjustments to the I.R.C. § 39 general business credit carryover, foreign tax credit limitation, and adjustments to NOLs. Examiners should make sure that all computational adjustments flowing from reversing an invalid I.R.C. § 280C(c)(3) election are addressed.

Section 280C and “protective elections”. A valid section 280C(c)(3) election can only be made by actually computing and claiming the reduced (13%) credit on taxpayer’s original, timely filed tax return. Taxpayer can not make a valid election without claiming the credit, by merely writing the words "280C", or by making a statement on the original tax return that taxpayer elects section 280C in the event that they later determine that they have research credit. If the taxpayer files an amended return claiming the reduced credit under section 280C(c)(3), when they did not claim credit at the reduced rate on the original timely filed return, the election is invalid and the claim should be returned to taxpayer to correct.

Section 41(f)(3) provides rules for computing the research credit after the acquisition or disposition of a trade or business. Although the Service has yet to issue regulations on the application of this section, many taxpayers fail to apply the plain language of section 41(f)(3). The Research Credit Technical Advisors strongly recommend that examination teams seek their assistance, in conjunction with Issue Counsel, on the application of section 41(f)(3).

Section 41(c)(5)(A) requires that a taxpayer establish consistency between the QREs claimed in the current year(s) and the QREs it paid or incurred during its base years (December 31, 1983 through January 1, 1989). This issue should be addressed with the taxpayer upon commencement of the audit. See I.R.C. § 41(c)(3)(C).

Section 41(f)(1)(A)(i) provides that all members of the same controlled group of corporations shall be treated as a single taxpayer. Likewise, all trades or businesses (whether or not incorporated) which are under common control shall be treated as a single taxpayer. Examiners should verify that the taxpayer has included all related entities in its research credit computation, regardless of whether these other entities have research expenses.

c. Development and Presentation of Issues

(1) Notice of Proposed Adjustment/ Revenue Agent Report and Report Writing

The Notice of Proposed Adjustment (i.e. NOPA - Form 5701) or Revenue Agent Report (RAR) should include all details as to why the projects were not qualified for the credit, as well as detail as to what the project actually was. Organizing the NOPA into sections of small, mid-size, and large projects, or other categories, can be helpful for the examiner to organize his/her thoughts about the issue, and in communicating with the taxpayer. For cases going to Appeals, take the extra time to make the NOPA and RAR as complete as possible, as this will help the Appeals Officer. Sometimes the workpapers go with the RAR, other times they do not.

Each report narrative should contain a discussion explaining the nature of each challenged research project (or other research credit related adjustment, such as the base year amount computation) in plain English. It is important to take the time necessary to clearly state the facts of the case, state why an adjustment should be made, and to clearly state why the taxpayer’s position is not correct. Every important fact or argument should be clearly stated.

It is imperative to get a good handle on the facts involving each research project that is disallowed. Spending time reviewing the research projects that are worthy of examination is essential, and helps to isolate any factual discrepancies that must be resolved before applying the law. A clear discussion of the agent’s understanding of the facts of the case is very beneficial in properly applying the law at the Appeals level.

All documents that an examiner is relying upon regarding a research project should be in the RAR as exhibits or included in the workpapers so they can be easily accessed. The binders presented by many taxpayers are voluminous, and are often impossible to work with efficiently.

(2) Substantiation and Documentation

It is a perfectly reasonable rationale for disallowance to assert that the substantiation supporting the claim(s) is inadequate. However, such a disallowance needs to be supported by an analysis of what is relied upon by the taxpayer and why it is unreliable, insufficient, irrelevant, misleading, etc. That is, the foundation must be enumerated in detail to support the disallowance.

If a claim has been disallowed due to inadequate substantiation, it would further support the determination if the examiner's methodology were detailed. Detailing the examiner's methodology would start with the identification of the taxpayer’s cost accounting system and an explanation why this is the "best" evidence (or normally would be the best evidence). The explanation then could identify the records maintained (or not maintained) for this system. (For example, how are programmer/ engineer/ consultants "activities" accounted for and where in the workpapers is the IDR requesting the records used to substantiate these activities)?

It is expected that examiners will request the documentation necessary to evaluate the claim. If evidence is not asked for, then it is presumed to be immaterial to the conclusion reached. If new documentation is later presented, that is related to a material issue request, Appeals should/must return this for evaluation by the examiner. (IRM 8.2.1.2.2). If new information is submitted at Appeals that was not deemed important (i.e. material) by the examiner, then independent evaluation and reliance by the Appeals Officer is reasonable. It is important to note in the file if an item was requested, and if the taxpayer chose not to provide it, whether due to cost or time involved, or unavailability. Again, if the item is material, the examiner should get a statement in writing from the taxpayer that they do not have the information requested; otherwise the examiner should consider summonsing the information. This is to prevent taxpayer from submitting the information later if they go to Appeals. It is not an Appeals Officer's responsibility to review documentation that should have been verified by the examiner.

Note that consistency and computational issues not raised by examiners are not raised at Appeals (unless material, which arguably, is relative and may be subjective).

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