

## KBKG Insight: Avoid Common R&D Expense Documentation Errors

Business owners are often surprised to learn they may be able to claim the Research & Development (R&D) tax credit. The credit was originally created as way to encourage American

companies to conduct R&D activities domestically. While initially thought to apply to large companies with formal R&D departments, “smaller businesses” in a wide range of industries, such as manufacturing, engineering, software development, architecture, pharmaceutical, aerospace and defense, metal foundries, chemical companies and others, have discovered they can also claim the benefit. However, it’s important to be aware of best practices when claiming the credit, especially in areas where issues commonly arise, such as a lack of supporting documentation. Mistakes in documenting qualified research can result in missed opportunities and create problems should the company be selected for an IRS audit. To help clients, prospects and others avoid common documentation mistakes, KBKG has provided a summary of common errors and best practices below.

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### Common Documentation Mistakes

- **Lack of Supporting Documentation** – R&D tax credit studies are at their weakest when they lack contemporaneous supporting documentation. Studies are often performed after the tax year is closed out. Some studies are comprised simply of a report that summarizes the findings and a brief description, if any, of the qualifying business component. One of the objectives of an R&D tax credit study should be to answer a common question under audit: Why does this business component qualify? In order to properly address this question, it’s important to take a fluid approach to documentation. No two taxpayers are the same. No two projects are the same. As such, taxpayers may need to be creative in the identification of documents that show how projects meet the qualification criteria with specific emphasis on the presence of uncertainty and experimentation. Information such as project records, lab notes, design drawings, photos of the design/build and testing trials, prototypes and patent applications are needed to corroborate customary R&D expenses. Having access to this information is especially helpful in the event of an IRS audit.
- **Informal Documentation Process** – If a company is considering claiming the R&D tax credit for a project, it would be useful to implement a formal documentation process before beginning. Because many companies don’t understand who should be documenting, what they should be documenting and when the process should be occurring, it’s often left as a task to complete at year-end. When this happens, a single person is often assigned the task of pouring over hundreds of documents to find proof of qualifying expenses. The result is that expenses are often missed, and the potential credit value is diminished. To overcome this, a best practice would be to implement a process that collects relevant information on an ongoing basis, while the R&D activities are occurring. The more thorough the process, the greater the likelihood that qualifying expenses will be captured and used appropriately when claiming the credit.
- **Lack of Clarity** – A common issue in the documentation process is that it’s unclear how the various expenses, personnel or other items relate to the R&D project. Remember that an IRS agent will not be familiar with your business, product or research process. Because they will be

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the primary judge of whether an expense qualifies toward the R&D credit, it's essential to ensure the relationship between the expense and qualifying activity is clear. Avoid incomplete or inadequate descriptions, general statements that sound canned and documentation that is not clearly related to the project. The more you rely on an IRS auditor to figure out how your documentation supports expenses, the greater the risk exposure.

### **Dangers of Improper Documentation**

Unfortunately, the IRS doesn't define what constitutes sufficient documentation to claim the credit, so the burden of proof falls on the taxpayer. Many companies that provide R&D consulting use a packaged template that provides research methodology but little direction or support on expense documentation. This can lead to problems for the taxpayer should the IRS decide to conduct an audit. Recreating expense documentation on demand is not only stressful but can be very difficult or even impossible given the time discrepancy between when a credit was filed and then ultimately reviewed. Imagine having to drop everything to gather invoices, timesheets and other facts from several years ago. In addition, if the IRS disallows the claimed credit, taxes in the year the credit was claimed as well as additional tax years are impacted. This can result in the need to re-file prior tax returns and the possibility of additional taxes being owed.

### **Contact Us**

KBKG has conducted dozens of R&D tax credit studies, and our clients have been able to defend their claims in IRS tax audits. Our team goes beyond a templated approach to provide peace of mind to business owners and management that their credit is properly documented, claimed and filed. If you have questions about documentation best practices or need assistance with claiming the R&D tax credit, KBKG can help. For additional information, click here to [speak to one of our R&D experts](#).

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