Why R&D Tax Credit Audits go Badly
(and what taxpayers can do to mitigate the risk)

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September 24, 2015
Introductions

Peter Mehta
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Peter’s 20 years of experience in tax controversy and R&D tax credit matters includes all aspects of tax controversy from Exam through the Appellate-level with both the IRS and California State taxing authorities. His experience includes audit examinations, technical advice requests, preparing and reviewing protests, IRS Appeals proceedings, and refund claims.

Bryan Auernig
Director, Business Development

• 7+ Years In Tax Incentive Field
• Former ADP Sales Executive specializing in CPA focused channel
• Regular contributor to CPE and speaking engagements
Objectives

- Understand the Lifecycle of an R&D Tax Credit Audit
- Describe the Common IRS Objections to R&D Tax Credit Studies
- Explain Strategies for Proactively Mitigating Audit Risk and Best Practices
- Questions
Introduction

 The I.R.C. section 41 R&D tax credit has been a source of contention between taxpayers and the IRS.

 Historically, the R&D credit is a difficult area of the tax law for taxpayers to comply with and for the IRS to enforce.
  – Determining whether a project satisfies the R&D requirements is often a subjective analysis and source of dispute
  – Most companies do not have project tracking and therefore rely on estimates to calculate their qualified research expenses (“QREs”)

 3 areas of IRS focus during an audit and issues arise during each phase:
  – IRS will audit taxpayer’s R&D study methodology
  – IRS will then audit whether the project activities qualify (satisfy the R&D four-part of I.R.C. section 41)
  – And only then will the IRS audit the numbers (do the costs claimed reasonably reflect the level of R&D being performed)
R&D Tax Credit Study Methodology:

- Common IRS Objections
- Risk Mitigation and Best Practices
Historical Overview

- Methodology
  - Definition: Refers to the approach utilized by the Taxpayer to identify qualified research activities at the business component level and the method by which it allocates research costs to those business components.
  - IRS thinking on acceptable methodologies has shifted over the last 15 years.
  - However, IRS examiners continue to disallow credits based on a finding that the taxpayer’s methodology is fundamentally flawed or defective.

  - IRS acknowledges 3 approaches to claiming R&D credits:
    - Cost center, project accounting, and hybrid approach
  - Concludes that all 3 approaches permissible:
    - “Examiners should avoid the “trap” of unnecessarily restricting their audit to the taxpayer’s cost capturing approach, as opposed to examining the research credit that was claimed. Audit adjustments based solely upon critiques of the taxpayer’s cost capturing approach usually stand little chance of being sustained in Appeals or in court.”
Historical Overview

- 2005-2011: IRS shifts position – cost center and hybrid approach are defective
  - 2005 Audit Techniques Guide (“ATG”):
    - IRS expressed concerns about “pre-packaged submissions” prepared by third-party tax providers
  - 2007 R&D Designated as Tier 1 Issue:
    - Tier 1 = an issue with significant potential for abuse
    - Much greater scrutiny as consequence of designation
    - IRS R&D technical advisors issued mandatory Tier 1 IDR addressing questions about taxpayer’s methodology
      - IDR consisted of 19 multi-part questions about the taxpayer’s methodology
    - Credits denied if based upon review of the IDR responses, the IRS concluded the methodology was unsound
  - LMSB Briefing Paper (2009):
    - Hybrid approach defective because does not make a direct connection between the expenses claimed and specific projects. Briefing paper states that the approach has little chance of being sustained in Appeals.
Historical Overview

- Mid 2011 – Present: IRS relaxes its position
  - In 2011, IRS abolished issue tiering, disbanded technical advisors who often had decision making authority to settle R&D credit claim audits.
    - Many of the ex-technical advisors were assigned as R&D specialists under the new IRS R&D Issue Practice Group
  - Favorable case law - *Union Carbide* and *McFerrin* made clear that project accounting not required
  - Unfavorable case law - *Bayer* reinforced principle that IRS may require taxpayers to prove qualified research at the business component level.
  - As a result of these changes, the current standard being adopted by the IRS is that a taxpayer must prove qualified research for a sufficient number of representative sample projects so that the IRS is comfortable with extrapolating the results from the sampled projects to the total QREs being claimed
  - Once a taxpayer can prove qualified research, then IRS is required to estimate the total research costs
Methodology – Common IRS Objections

- IRS often has difficulty understanding how the research credit or refund claim was put together (i.e., they sometimes ignore the information provided as part of the study deliverables).

- The R&D study does not provide the IRS Examination Team with an audit “roadmap” (i.e., an ability to audit the projects for qualification, identify non-qualified projects and activities, and make any required adjustments).

- Biased judgement sample of limited number of projects supported by employee time surveys does not provide adequate basis to extrapolate results to all projects/activities for which qualified research expenses were claimed.
Methodology – Common IRS Objections

- The process by which the qualified percentage assigned to an employee was determined and what information was relied upon

- No “nexus” between the costs claimed and the business component
  - What is the universe of projects and how did the taxpayer establish the link between the qualified research expenditures (“QREs”) being claimed and the business component
  - Analysis not done on a project-by-project basis
  - Costs are not allocable to projects
Methodology – Common IRS Objections

- Often there is poor nexus between employee wage QREs and activities
  - Solely based on employee testimony ≠ nexus per IRS
  - No documentation to link the employee to activities
  - Project tracking (if it exists) fails to describe what the employee did
  - No support to establish credibility of the employee

- Allocations to projects
  - No costing detail to support allocations to projects
  - No documentation to support the allocation
  - Nothing more than an estimate
Methodology – Risk Mitigation and Best Practices

- Develop and document a methodology that provides an audit roadmap that enables the IRS to establish an audit plan at the beginning of the examination.

  - Benefits:
    - Forces IRS to audit based on the taxpayer’s study, and its books and records
    - Eliminates IRS “fishing expeditions” issuing IDR to understand what was done for purposes of developing an audit plan
    - Reduces risk that IRS will substitute its own audit plan in lieu of the taxpayer’s study
Methodology – Risk Mitigation and Best Practices

- A robust methodology should:
  - Describe each stage of the taxpayer’s product development process from idea generation to commercial production
    - Product development process often tracks the statutory requirements of I.R.C. section 41
    - Collect any documentation evidencing the process (ISO documentation, workflow, etc.)
  - Map the departments, employee job titles, and employee activities to each stage
  - Discuss representative projects and how they meet the four-part test
    - If number of projects is too large, then roll up projects into initiatives and cover subset of projects within each initiative
    - The goal is to document a representative sample set of projects to get sufficient coverage so that the IRS would be willing to extrapolate the results to the total set of projects/activities.
Methodology – Risk Mitigation and Best Practices

▪ Document the methodology used and include in deliverable (be specific)

▪ Benefits
  – Establish credibility from the start
  – Provide IRS w/understandable and organized explanation of the claim

▪ Methodology Memoranda
  • Should be easy to understand
  • Provides an overview of the taxpayer’s R&D organization and process that is tailored to client
  • Shows a balanced approach - explain also what client didn’t qualify
  • Addresses concerns raised in the Audit Techniques Guide, including base period
  • Summarizes documentation – included in study plus what the company has available, as needed
Methodology – Risk Mitigation and Best Practices

- Methodology should strengthen the nexus between an employee’s project activities and the costs claimed
  - If at all possible, use the “double blind” survey
  - Qualify and disqualify projects
  - Qualify and disqualify activities performed on all projects
- Employee recollection with documentation support
  - Specific examples linking employees to documented projects / activities
  - Employees sign-offs for their QRE percentage
- IRS wants to know: How did employee calculate its qualified percentage
  - Give the employee a chance to review records before providing a qualified percentage
  - Describe how the employee determined their qualified percentage
  - Have the employee rely on documents and not just memory
Methodology – Risk Mitigation and Best Practices

- Allocations to projects
  - Gather support that methodology is reasonable and accurate
  - Have employee sign off to support accuracy of allocation and credibility
  - Some specific examples to show the nexus
  - Only allocate costs that are connected to the project
Activity Identification:

- Common IRS Objections
- Risk Mitigation and Best Practices
Federal R&D Credit Rules

- I.R.C. § 41 provides a credit for 20% of Qualified Research Expenditures (QRE’s) over a historical base period amount or can elect the Alternative Simplified Credit (“ASC”) method.

- To be eligible, the taxpayer must engage in activities that meet the “four-part” test of § 41(d):
  
  - **Permitted Purpose:** The company must be working to develop a product, process, computer software, technique, formula, or invention (“Business Component”) which is to be held for sale, lease, or license, OR used by the taxpayer in a trade or business of the taxpayer
  
  - **Elimination of Uncertainty:** Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component
  
  - **Process of Experimentation:** 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 as of the beginning of the taxpayer's research activities
  
  - **Technological In Nature:** The process of experimentation used to discover information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science
Qualifying Project Analysis – Common IRS Objections

- No Technical Uncertainty
  - No uncertainty related to capability, methodology or design
  - Uncertainty was resolved, therefore QREs claimed are overstated
  - Uncertainty limited to subset of project (ex. component vs. product), therefore QREs are overstated

- No Process of Experimentation
  - IRS examiners often view activities in isolation to determine qualified research instead of focusing on the taxpayer’s entire development process as the process of experimentation of which the activity being viewed in isolation is simply a qualifying activity
  - Experimentation and testing was simply performed to validate a design the developers knew would work. The experimentation not conducted to resolve a technical uncertainty.
Qualifying Project Analysis – Common IRS Objections

- Process of experimentation was not systematic, formal and structured process in the “scientific” sense
  - Ad hoc trial and error instead of identifying an issue, forming a hypothesis to resolve that issue, testing that hypothesis, and then refining, modifying or abandoning that hypothesis.

- Insufficient contemporaneous documentation supporting four-part test at the project level
  - Taxpayer’s rely too heavily on employee testimony describing project activities from prior years.
  - Technical reports prepared by the taxpayer are inherently unreliable because they are self-serving and often prepared many years after the fact
  - The documentation presented does not support elements of the four part test.
Activity Qualification – Risk Mitigation and Best Practices

- Collect project lists detailing major project initiatives (both qualified and not qualified) for each department included in the claim.

- Identify and document a representative sample or subset of the projects demonstrating how four-part test is met at business component/project level.
  - Aim for a minimum of 60% QRE project coverage.
  - If number of projects too large, roll similar project types into project initiative or categories.
  - Don’t “cherry-pick” strongest projects.
  - Collect contemporaneous documentation and tie to examples of technical uncertainty and process of experimentation discussed in the technical reports.
  - Have employees verify and sign-off on accuracy of the information contained in the technical reports.
Cost Accumulation:

- Common IRS Objections
- Risk Mitigation and Best Practices
Cost Accumulation – Common IRS Objections

- Employee time surveys to allocate time to qualified and non-qualified activities are unreliable
  - Time surveys are not contemporaneous documentation or evidence.
  - Self-serving, unreliable and often completed years after the fact
  - Surveys do not allocate time spent on qualifying projects but merely allocate time to specific project activities. This is inconsistent with requirement that four-part test for qualification be performed at the business component level.
    • Not all new product development would qualify. Similarly not all activities on otherwise qualified projects would qualify
  - No documentation supporting allocation of time to projects and activities

- Failure to substantiate base period
  - Consistency not established
  - Base period recreated using extrapolations and estimates from current years all the way back to 1984-88 period
Cost Accumulation – Risk Mitigation and Best Practices

- Time surveys should be modeled after “double-blind” survey
  - Employees should assign time to projects they worked on during the year (or project categories)
  - Employees should assign the time they spend on all activities (qualified and non-qualified) on all projects (ex. design, testing, G&A, foreign travel, etc.)
  - Surveys should be “blind” in the sense that the employees completing the survey do not know which projects and activities qualify and which do not.
  - Tax provider is expert on R&D credit and therefore should determine whether facts provided by employee constitute qualified research
Cost Accumulation – Risk Mitigation and Best Practices

- Employee allocations should be based on a review of employee documentation, not simply an unsupported guess
  - Employee should gather any relevant documentation that would assist in the allocation of time spent on qualified vs. non-qualified projects and activities
  - Employee should attest to accuracy of information in time survey.
- Ratio of employees completing time surveys for other employees should be as small as realistically feasible.
  - *Eustace* case: Court held that time surveys prepared by an employee in tax department of a company were inherently unreliable where employee filled in qualifying percentages for approximately 200 engineers
Questions
Key R&D Credit Team Profiles

- Peter Mehta, J.D., LLM, Managing Director, R&D
  - 20 years experience in Big 4; 12 in tax controversy
  - Works extensively with IRS Engineering and MITRE specialists nationwide

- Dan Laughlin, J.D., Director, R&D
  - Former Senior Manager in Big 4 national R&D practice
  - Project managed large R&D engagements for Fortune 500 companies

- Kim Hopkins, Ph.D., Director
  - Ph.D. in Computational Algorithms, Mathematics
  - Former researcher for National Science Foundation

- Elizabeth Chic, J.D., Senior Manager, R&D
  - 10 years experience with National Big 4 R&D and Controversy service lines
  - Symposium Editor, The U.C. Davis Law Review

- Christopher Petros, B.S. Aerospace Engineering, M.S. Systems Engineering, Manager, R&D
  - Lead technical resource for aerospace industry
  - Former project manager at Northrop Grumman Aerospace in manufacturing, lean processes, production, and design

- Kawika Maunupau, B.S. Systems Engineering, Senior Associate, R&D
  - Lead implementation associate for aerospace industry
  - 6 years experience in systems engineering, continuous improvement, and data analysis at Northrop Grumman