

# **MANAGING AND RESOLVING R&D ISSUES**

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# AGENDA

- Assume basic working knowledge of section 41 but please ask questions
- Review two important recent developments – proposed IUS regulations and *Suder v. Commissioner*
- Give practical advice for identifying QREs, claiming the credit, defending your claims, and resolving issues
- Review common IRS arguments and how to deal with them
- Discuss the elephant in the room (i.e., substantiation)

**KEY DEVELOPMENTS –  
THE PROPOSED IUS REGULATIONS  
AND *SUDER V. COMMISSIONER***

# PROPOSED INTERNAL USE SOFTWARE (IUS) REGULATIONS

- Congress excluded IUS research “except to the extent provided in regulations” in 1986, the year in which IBM introduced the first PC.
- Software now pervades how businesses interact with their customers, vendors, and others.
- The rapid pace of technological advancement has made the IUS exclusion difficult to administer.
  - 3 sets of regulations with varying definitions and standards.
  - IRS hostility to IUS claims, creating perception that nothing will qualify and not worth the effort.
- On 1/20/15 Treasury and the IRS proposed new IUS regulations that are widely applauded.

# PROPOSED IUS REGULATIONS

- Definition of IUS narrowed
  - IUS = software developed for use in G&A functions, i.e., financial management, HR, and support services.
  - IUS  $\neq$  software developed either (1) to be sold, leased, licensed, or marketed; or (2) to interact with 3Ps or allow 3Ps to initiate functions or review data (e.g., banking, track delivery, purchase tickets, etc.).
- “Dual function computer software”
  - Presumed to be IUS but allows TPs to identify “3P subset” and allocate costs
  - Also, safe harbor whereby TPs can include 25% of QREs for dual function subset if 3P interaction > 10%.

# PROPOSED IUS REGULATIONS

- 3-part “high threshold of innovation” test
  - Innovation = A reduction in cost or improvement in speed or other measurable improvement that is substantial and economically significant if development were successful.
  - Significant Economic Risk = TP commits substantial resources and there is substantial uncertainty because of technical risk that these resources will not be recovered within a reasonable period.
    - Appropriate design uncertainty alone is insufficient.
  - Commercially unavailable = Cannot be purchased, leased, or licensed and used for intended purpose without modifications satisfying the first two tests.

# PROPOSED IUS REGULATIONS

- New POE test examples (Reg. § 1.41-4(a)(8))

QUALIFIES	DOES NOT QUALIFY
Design, testing, and evaluation of several new load balancing algorithms	Evaluating vendor software products and applications
Systematic trial and error of several newly designed data caching algorithms	Evaluating object-oriented functions (e.g., shopping cart) in a vendor package
	Incorporating selected functions into a new web application
	Selecting separate server and round-robin algorithm to distribute workload
	Implementing ERP system (i.e., evaluating available templates, programs, etc.)

# PROPOSED IUS REGULATIONS

- Public hearing held on April 17, 2015.
  - Make the regulations retroactive to taxable years ending before January 20, 2015.
  - Eliminate the dual-purpose software provision as too difficult to administer.
  - Remove the design uncertainty exclusion from the Significant Economic Risk test.
- When will the Treasury Department and the IRS will issue final regulations?



# ***SUDER V. COMMISSIONER,*** **T.C. MEMO. 2014-201**

- Involved research credit claims of S Corp telephone manufacturer ESI for 2004-07.
- CEO Suder was the “chief idea guy” and “product visionary.”
- ESI employed a systematic product development process (concept→hardware→software→testing).
- Parties stipulated to 12 of 76 representative projects.
- SVP P/D Wende derived qualified services allocations
  - 75% for CEO, 100% for SVP, 100% for engineers, product managers, etc., 5-10% for QC, shipping, etc.
- 2/3 of claimed wage QREs from CEO (\$8.7-\$11MM in salary)
- IRS disallowed claims and imposed penalties.
- 3-week trial, 3.5K pages of testimony & 170K pages of exhibits

# ***SUDER V. COMMISSIONER,*** **T.C. MEMO. 2014-201**

- Nexus exodus!
  - On the basis of SVP Wende’s testimony, the court rejected the IRS’s argument that ESI “failed to provide any *nexus* between the expenses claimed and qualified research activities, if any, performed.”
  - Testimony of a knowledgeable and credible witness was sufficient to establish percentages of qualified wages of employees conducting research without allocation among projects.
  - This contentious issue, referred to by the IRS as the “nexus” requirement, has not previously been addressed by a court.
  - Applied *Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930) (the “Cohan rule”) and *US v. McFerrin*, 570 F.3d 672, 679 (5th Cir. 2009), in a situation in which the IRS has claimed their estimation principles do not apply.

# ***SUDER V. COMMISSIONER,*** **T.C. MEMO. 2014-201**

- Other *Suder* “goodies”
  - Projects that the IRS argued were “routine engineering” or “duplications” of existing products were found to qualify because of uncertainty and systematic development process, even though they were not rocket-science type projects.
    - “Neither section 41 nor the regulations thereunder require taxpayers to ‘reinvent the wheel.’”
  - Activities of CEO *Suder* were qualified services (75% claimed).
    - Not excluded simply because he was above a first-line manager.
    - CEO spent much of his time “in the trenches,” brainstorming and actively participating in engineering and testing.
  - Patent application expenses held qualified (no analysis).
- Unreasonable compensation
  - Court held that a substantial portion of the CEO’s salary (\$8.7-11MM) was unreasonable compensation under section 174(e).
  - First reported case in which this section 174(e) issue was addressed.
  - Primarily an issue for closely-held companies.

**PRACTICAL ADVICE FOR  
IDENTIFYING QRES AND CLAIMING THE  
CREDIT, DEFENDING YOUR CREDIT ON  
AUDIT, AND RESOLVING DISPUTES**

# IDENTIFYING QRES AND PREPARING YOUR CLAIM

- Claiming the research credit is not easy.
- Requires dedicated resources and systems for—
  - Identifying qualified research activities
  - Identifying and quantifying QREs
  - Computing your credit – Regular credit versus ASC
  - Gathering the records and data to substantiate the credit
- Considerable manpower, cooperation, resources, and time are required.
- The sophistication and focus of the methodology depends on your business, the potential value of the credit, and expected level of scrutiny.

# IDENTIFYING QRES AND PREPARING YOUR CLAIM

- Original versus amended returns.
- All factors equal, the closer in time to the R&D the better.
  - Collecting information real-time vs. after-the-fact forensic accounting
- Leverage available tools:
  - Statistical sampling – Rev. Proc. 2011-42
  - Project and time tracking software programs
  - Online surveys
  - Post hoc project tracking
    - Project lists and allocations
    - “Chunky peanut butter” approach
  - RCRA’s – Notice 2004-11 (provide a substantiation safe harbor)
  - PFAs re appropriate methodology – Rev. Proc. 2009-14
  - Informal agreements with your exam team

# IDENTIFYING QRES AND PREPARING YOUR CLAIM

- The best offense is a good defense.
- Data gathering:
  - Taxpayers armed with contemporaneous documents are best positioned.
    - No particular type required; documents created in normal course of your R&D are best.
      - Monthly reports
      - Capital authorizations
      - Lists of patents and patent applications (and similar technical certifications)
      - Project lists
    - Consider the section 41(d) qualified research tests when gathering documents.
      - Establishing (1) technical uncertainties and (2) evaluative processes.

# CLAIM PREPARATION

- Data gathering and maintenance
  - Consider all available sources of information: public information, tracking systems, internal records, site visits, in-house experts, etc.
  - Leverage technical and accounting personnel.
    - Explain QRE definition with emphasis on avoiding any preconceived notions of what “research” must be
    - Establish a pipeline for future project information and changes in department activities
  - Memorialize interviews and surveys but recognize they’ll be requested and may not be privileged.
- Data retention; may need to override normal document retention (destruction) policies



# DEFENDING YOUR CLAIM ON AUDIT

- Anticipate and prepare for potential audit issues. Be out front.
- Try to maintain a good rapport with your exam team.
  - Be courteous and responsive and adhere to deadlines.
  - Pick your battles, but stand your ground and elevate where appropriate.
  - What are the agent's objectives?
- Consider statistical and judgment samples up front to streamline the audit.
- Consider other ways to cut through the big-ticket issues.
- The facts are your friend. Don't be afraid of them.
- Fully prepare your witnesses (i.e., soda machines) for interviews.
- Identify additional QREs and gross receipts, consider affirmative claims.
- Recognize that the consistency requirement is a two-way street.

# RESOLVING YOUR R&D ISSUES IN APPEALS

- Your protest should be better and more persuasive than the NOPA.
  - Describe the company and its research in clear, understandable terms.
  - Show why the research satisfies I.R.C. § 41(d).
  - Attack the NOPA's contentions.
- Cases are won, lost, and settled based on their facts
- Consider how best to leverage your in-house experts.
- Do you need an outside expert?
- Objectively evaluate the merits and hazards of your position.
- Consider ADR alternatives: Fast Track, DO 4-24, etc.

# **COMMON IRS OBJECTIONS (I.E., WHAT TO BE READY FOR)**

# COMMON IRS OBJECTIONS – SECTION 174 TEST

- Lack of uncertainty concerning capability, method, or design of the product
  - No objective uncertainty based on known facts (*Union Carbide*)
  - Uncertainty eliminated; experimentation has ended
  - Uncertainty limited to a component of overall system
- Government-mandated R&D does not qualify
- Construction and installation versus R&D costs
- Costs are for depreciable property or components thereof

# COMMON IRS OBJECTIONS – PROCESS OF EXPERIMENTATION TEST

- Requires experimentation in the “scientific sense” of formulating, testing, and refining alternative hypotheses in a highly structured way
- Insufficient taxpayer evaluation and analysis
- Activities are simply validation and troubleshooting, not experimentation
- Software maintenance, configuration, evaluation, debugging, modifications, upgrades, and code rewriting do not pass the test.

# COMMON IRS OBJECTIONS – EXCLUDED ACTIVITIES

- Research after commercial production – taxpayer’s functional and economic requirements are already satisfied
- Duplication and adaptation – reverse engineering, customization, etc.
- Internal-use software
  - Traditionally the IRS has applied exacting standards for innovativeness and technical/economic risk
  - Impact of proposed IUS regulations remains to be seen
- Funded research – research under a contract is funded unless the contract makes the customer’s payments explicitly contingent on success of the research (*Fairchild* and *Geosyntec*).

# COMMON IRS OBJECTIONS – QREs

- Wages
  - Direct support –activities not normally be done by a researcher ineligible; focus on employees in administrative, manufacturing, marketing, regulatory, legal, etc. functions
  - Direct supervision – above first-line managers categorically excluded
    - Technical-degreed high-level executives often perform direct research and directly supervise research
      - a) Effective hierarchy of technical departments is often very flat and VPs of technical departments often heavily involved in actual research and direct supervision of research
      - b) Brainstorming and technical problem solving are themselves research, not supervision
      - c) Directly supervising first-line managers when the first-line managers are performing research is direct supervision
      - d) Executive questionnaire (see handout)
  - Insufficient “nexus” between compensation and R&D activities
    - Bonuses based on company performance
    - Severance payments (2013 IRS NSAR 1102F)

# COMMON IRS OBJECTIONS - QREs

- **Supplies**
  - Purchased primarily for non-research purposes; not directly related to performance of qualified services
  - Overhead, G&A, depreciation allowances, leasing costs, license fees, etc.
  - Depreciable property (e.g., prototypes)
- **Contract research expenses**
  - Nature of work per contract documentation (e.g., SOW)
  - Taxpayer must be at risk for success of research
  - Ineligible expenses – e.g., offshore work, licenses, routine services, etc.
- **Distinguishing contract research at risk and not at risk, on one hand, from contracts for qualified supplies, on the other (see handout)**



# COMMON IRS OBJECTIONS – RESEARCH CREDIT COMPUTATION

- Omission of controlled group members and common-control entities
- Omission of gross receipts from prior 4 years
- Inconsistent determination of QREs in credit versus base years
- Failure to adjust fixed-base percentage for acquired businesses
- Validity of section 280C(c) election

# **THE ELEPHANT IN THE ROOM (I.E., SUBSTANTIATION )**

# **SUBSTANTIATION – THE IRS’S PERSPECTIVE**

- Because tax credits are matters of “legislative grace,” taxpayers bear a heavy burden to prove entitlement.
- Taxpayers are required to establish a factual “nexus” between claimed QREs and specific business components.
  - Particularly difficult for taxpayers with cost center accounting and wide-ranging R&D activities.
- Contemporaneous project-based documents are much more reliable than oral testimony.
- Retrospective look-back studies are inherently unreliable.
- Not required to accept estimates or extrapolations.

# **SUBSTANTIATION – THE IRS’S PERSPECTIVE**

- **Standard IDR requests**
  - “Identify and list each new or improved business component for which the QREs are being claimed.”
  - “For each business component identified in item a, provide the QRE wages by employee, the QRE supplies, and the contract QREs by contract, and reconcile the QREs by business component to the total QREs on your Form 6765.”
  - “Does the claim rely on any oral testimony or employee surveys to determine the QREs in the credit years?”
  - “Does the claim rely on estimates or extrapolations to determine any portion of the QREs in the credit year?”
- **Standard NOPA language**
  - “The taxpayer’s reconstruction of claimed QREs is unreliable, incomplete, and wholly insufficient to establish that its claimed research expenditures qualify for the research credit.”

# SUBSTANTIATION – LEGAL PRINCIPLES

- Taxpayers “must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.” Reg. § 1.41-4(d).
- But the legal authorities also establish:
  - Eligibility not contingent on meeting unreasonable record keeping requirements.
  - Taxpayers should be accorded “reasonable flexibility” in the manner in which they substantiate their research credits.
  - No particular types of documents are required.
  - Claims may be supported by credible oral testimony.
  - Estimation is allowed (or required) where the taxpayers perform qualified research and provide a reasonable basis.

# THANK YOU.



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