Audit Techniques Guide:
Credit for Increasing Research Activities
(i.e. Research Tax Credit)
IRC § 41*

Internal Revenue Service
Large and Mid-Size Business Division (LMSB)
Pre-Filing and Technical Guidance (LMSB:PFTG)

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

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1. INTRODUCTION

This Audit Techniques Guide ("ATG") sets forth the Research Credit Technical Advisors' suggested guidelines for auditing research credit issues. Examiners should consider adopting these guidelines, in whole or in part, when auditing the research credit. This audit plan is not an official pronouncement of the law or the Service's position and cannot be used, cited or relied upon as such.

The following issues are not addressed in this ATG:

a) Amounts paid to certain research consortia. I.R.C. § 41(b)(3)(C).

b) Payments to qualified organizations for basic research. I.R.C. § 41(e).

c) The internal-use software exclusion. I.R.C. § 41(d)(4)(E).

d) Research and experimental expenditures. I.R.C. § 174.

e) International issues. Amounts paid or incurred for research impact many international tax issues, such as foreign tax credits, inter-company transactions, and the allocation and apportionment of expenses. You should coordinate your audit of research expenses with the International Examiner assigned to your case.

Please contact a Research Credit Technical Advisor if you need assistance with these issues.

Section 41 allows taxpayers a credit against tax for increasing research activities. Generally, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's qualified research expenses ("QREs") for the taxable year over the base amount, and 20 percent of the taxpayer's basic research payments.

The research credit provisions originally appeared in section 44F of the Internal Revenue Code of 1954, as added to the 1954 Code by section 221 of the Economic Recovery Tax Act of 1981. Section 471(c) of the Tax Reform Act of 1984 redesignated section 44F as section 30. Section 231 of the Tax Reform Act of 1986 redesignated section 30 as section 41 and substantially modified the research credit provisions. Congress revised the computation of the research credit in the Revenue Reconciliation Act of 1989.

The research credit was not in effect for the period July 1, 1995 through June 30, 1996. The Small Business Job Protection Act of 1996, P.L. 104-188, reinstated the research credit for the period from July 1, 1996 through May 31, 1997 (i.e., 11 months); thereafter the research credit was extended to June 30, 1998 and June 30, 1999[1]). Under the Tax Relief Extension Act of 1999, P.L.

[1] The Tax Relief Extension Act of 1999 requires that any research credit attributable to the period from July 1, 1999 through September 30, 2000, that is otherwise allowable under the Code, may not be taken into account before October 1, 2000. Likewise, any research credit attributable to the period from October 1, 2000 through September 30, 2001 may not be taken into account until October 1, 2001. For any return that covers a period overlapping one or both of the above suspension periods, the research credit is first calculated for the full tax year, and is then prorated by the number of months falling within the suspension period. Such portion must be deferred until after the end of that suspension period. The suspended amount of credit may be claimed by filing an amended return, an application for expedited refund, or an adjustment of estimated taxes. See Notice 2001-2; 2001-2 IRB 1 (December 6, 2000).

106-170, the research credit was extended to June 30, 2004.[2] The Working Families Tax Relief Act of 2004, P.L. 108-311, further extended the research credit to December 31, 2005.

Commerce Clearing House ("CCH"), the Bureau of National Affairs ("BNA"), and the Research Institute of America ("RIA") have published helpful materials on the research credit. These materials are available on Westlaw and/or LEXIS. 2004 Stand. Fed. Tax. Rep. (CCH); Cohen, 556 T.M., Research and Development Expenditures; 2004 U.S. Tax. Rep. (RIA).

2. DETERMINING THE SCOPE

a. Review Form 6765 - Credit for Increasing Research Activities

To claim the research credit, a taxpayer must complete and attach Form 6765, Credit for Increasing Research Activities, to its tax return. Form 6765 must be properly completed. If the taxpayer has not properly completed Form 6765 in accordance with its instructions, the examiner should ask the taxpayer to make the appropriate corrections and should obtain the relevant information before proceeding further.

While reviewing Form 6765, take note as to whether the taxpayer has elected the alternative incremental credit ("AIRC") and/or whether the taxpayer has elected the reduced rate of credit under section 280C(c). These elections must be properly made on a timely filed original return, with extensions and, where applicable, the taxpayer must continue to use such method unless properly revoked. Form 3800 should likewise be reviewed to verify the proper flow-through of the research credit to the section 38 General Business Credit.

Form 6765 requires the taxpayer to allocate QREs among wages, supplies, and contract research expenses. A comparative analysis of the QREs with prior and subsequent years and a review of these expenses, in light of the taxpayer's business activity, are the initial steps in identifying areas with the greatest potential for compliance risk.

b. Research Credit Claims (Not on an Original Income Tax Return)

An overpayment of tax for a taxable year generated, in whole or in part, by the research credit and not taken into account on a taxpayer's original income tax return may be taken into account by the timely filing of an amended return (e.g., Form 1120X) with the appropriate Service Center or, where applicable, the timely filing of an application for an expedited refund (e.g., Form 1139).

In many cases, taxpayers have attempted to claim additional research credits in the course of an audit, without filing a claim for refund with the appropriate Service Center. Notice 2002-44[3], published in the Internal Revenue Bulletin on July 8, 2002, provides a central filing address for corporate research credit claims while offering a separate filing process to certain taxpayers under

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[2] Notice 2001-2 provides guidance on computing and reporting the research credit that includes a research credit suspension period described in section 502(d)(2) of the Tax Relief Extension Act of 1999.

[3] Notice 2002-44 Research Credit Claims (doc, 28kb)

audit. In order to receive administrative consideration by LMSB or SB/SE, all claims for credit or refund subject to Notice 2002-44 filed with the LMSB Team Manager/SBSE Manager (and a copy mailed to LMSB-PFTG) must include a completed Form 6765 and must, among other things:

(1) Set forth in detail each ground upon which a credit or refund is claimed,
(2) Set forth facts sufficient to apprise the Service of the exact basis thereof, and
(3) Be verified by a written declaration that is made under the penalties of perjury.

Accordingly, LMSB Team Managers/SBSE Managers should return claims for credit or refund subject to Notice 2002-44 that do not comply with these requirements to the taxpayer for correction. The acceptance of the claim and examination of the claim should be delayed until such deficiencies are corrected.

c. Prepackaged Submissions

Over the past several years, there has been a growing trend whereby taxpayers or their representatives submit prepackaged material to support their research credit claims. These prepackaged submissions are usually delivered to examiners in multiple binders, and often set forth the methodology employed in preparing the research credit claim.

Examiners have generally found that these prepackaged submissions fail to substantiate that the taxpayer paid or incurred qualified research expenses as claimed, and instead are found, after extensive review, to contain information not germane to the audit. In addition, many examiners may be unnecessarily restricting their audit to the taxpayer's methodology for capturing QREs and the prepackaged submission, as opposed to examining the research credit claimed. Audit adjustments based solely upon critiques of the taxpayer's methodology and prepackaged submissions, in many cases, stand little chance of being sustained in Appeals or in court.

It is strongly recommended that examiners resist relying exclusively upon these prepackaged submissions. Instead, the examiner should independently determine the documents and other information necessary, including testimony, to substantiate the taxpayer's claim for the research credit. To the extent that these documents and information are already contained in the binders, the taxpayer can reference the needed information quickly and at the appropriate time, thus conserving audit resources. This procedure should be explained to the taxpayer early in the audit to avoid any misunderstandings. As previously stated, deficient refund clams filed during the examination should be returned to the taxpayer for completion.

Certain documents may be created in the course of performing such a study that can be of enormous value. Although not part of the binders usually submitted to the Service in connection with a research credit study, the following documents should be routinely requested when auditing the research credit predicated upon a study:

- All documents concerning the taxpayer’s claim for the research credit that are not part of the study should be requested from the study provider and the taxpayer. Such documents would include, but not be limited to, any back-up or workpaper files retained by the study provider.

- All analyses of the taxpayer's risk or exposure on the positions taken in the study should be requested from the study provider and the taxpayer.

IDR/summons language should be drafted to capture these types of documents, and used any time that a research credit study is audited. Importantly, these are neither tax accrual workpapers nor are they audit workpapers, so any administrative restrictions applicable to requesting such information are not applicable here. Any claims of privilege asserted by the taxpayer or study provider in response to a request for this information should be coordinated with your local counsel and the Research Credit Technical Advisors.

d. Review the Taxpayer's Research Credit Computation Workpapers

The taxpayer's research credit computation workpapers (including the base amount computation workpapers), including years for which a claim for refund has been filed, should be reviewed. Reconcile the amounts reflected on the taxpayer's workpapers to Form 6765. The taxpayer should be asked to explain any discrepancies between the workpapers and Form 6765. Preparation of a spreadsheet reflecting comparative years' workpaper summary data will help identify any obvious trends from year to year.

Current year's QREs will be reported as wages, supplies, and contract research expenses. The workpapers may indicate whether the taxpayer is computing the research credit directly from general ledger accounts (i.e., listing the specific expenses that qualify) through either a cost center/departmental approach, or through a project accounting approach.

A copy of the taxpayer's chart of accounts and any accounting and finance procedures relating to the costs treated as QREs by the taxpayer should be requested. If the taxpayer computed the research credit using a cost center or departmental approach, the workpapers should identify each cost center or department by its appropriate cost center or department name and/or number. Detailed descriptions of cost centers or departments should be requested. If the taxpayer computed the research credit using project accounting, each project should be identified by its name and/or number. Project descriptions should be obtained, as well as the list of products or processes to which the research projects relate. The workpapers should also reflect the amount of each type of QRE (wages, supplies, and contract research expense) included in the computation.

If the taxpayer is a member of a controlled group of corporations or trades or businesses under common control under section 41(f)(5), the research credit computation workpapers should include all members of the controlled group required to aggregate under section 41(f)(1). Under the aggregation rules, QREs and gross receipts of a controlled group of corporations, and trades or businesses under common control, are aggregated. One credit is computed, and is then allocated to the group members. The mechanics of this computation should be reviewed. Additionally, related Forms 1065 and K-1 should also be reviewed for flow-through research credits.

e. Plan the Audit Strategy

The goal of any research credit examination is to verify taxpayer compliance in the most efficient and effective manner possible. LQMS case quality standards regarding:

(1) planning the examination,
(2) inspection and fact-finding,
(3) development, proposal and resolution of issues, and
(4) workpapers and reports

must be addressed, while at the same time, considering current Service audit policies and initiatives related to case currency, cycle-time, and audit risk assessment. For example, LIFE, PFA, and case currency considerations may require tailoring the audit because of limited resources and/or shorter cycle times. The following audit approach is recommended:

1. Review the research credit computation.

2. Determine whether the expenses claimed for the research credit are QREs under section 41(b) (i.e., wages, supplies, and contract research expenses).

3. Determine whether the activities constitute qualified research under section 41(d).

4. Audit the consistency requirement (base amount computations).

5. Address substantiation and recordkeeping requirements.

Examination of the research credit is unique, in that it requires, in part, an evaluation of technological activities to determine the qualification of research related to a business component. The decision whether to engage a specialist (engineer/computer audit specialist) or an outside expert should be made during the planning stage. If the activities are highly technical, consider requesting the services of a specialist.

A computer audit specialist (CAS) is helpful in extracting and sorting electronic data such as general ledger information and payroll records. A CAS can also assist in formulating sampling methodologies, as well as in assessing the technical aspects of software development or information technology activities.

Industries and sub-industries, e.g., Pharmaceutical, Aerospace, and Motor Vehicle, are occasionally appropriated funds for the hiring of outside experts. The respective Technical Advisor should be consulted to ascertain whether funding exists and/or for information concerning experts specializing in these industries.

The referral should specify the area of expertise needed, as it is beneficial for the engineer or expert to be familiar with both the taxpayer's technology and industry.

Audit strategy should be contemplated, and an initial planning meeting should be held with the taxpayer and its representative, if applicable, to gain a general understanding of how the taxpayer reached its return (or claim) position and formalize a general audit plan. All members of the audit team involved with the research credit issue, including local counsel as needed, should attend this meeting. Specialists/experts should be consulted before finalizing the audit plan/timeline.

Consider sending a letter or issuing an Information Document Request (IDR) prior to the meeting, addressing potential subjects for discussion and documents to be produced. Consider requesting that a taxpayer contact be designated for the research credit issue. Some potential issues for discussion and documents to be produced at the meeting are as follows:

- Who prepared the research credit computation workpapers?
- What methodology was employed for capturing QREs reflected in the research credit computation workpapers (e.g., estimates, interviews, sampling, surveys, and reviews of contemporaneous documents)?
- What documentation and other substantiation are available to support the taxpayer's claim for the research credit (including the base years)?
- Was this documentation prepared contemporaneously with the research activities?
- What legal standard(s), if any, did the taxpayer employ to determine credit-eligibility?

An assessment of the timeframe within which the examination will be conducted should be carefully addressed and actions to be taken should be planned within this constraint. Consider the audit history of the issue with each particular taxpayer and the number of years to be examined, as well the possible use of expedited resolution procedures. Taxpayer cooperation is critical in determining whether such expedited procedures are advisable.

Techniques should be employed to streamline the inspection and fact-finding process. Statistical or “judgment” sampling methodologies, where appropriate, may be employed. Relevant records must be identified and secured. IDR response procedures should be established, and ongoing lines of communication maintained with the taxpayer throughout the examination. It is desirable to schedule with the taxpayer, in a chronological fashion, the examination processes, and procedures during the planning phase.

At the meeting with the taxpayer, determine whether the taxpayer sent surveys/questionnaires to employees. If so, request copies of these surveys/questionnaires and responses and have the taxpayer show how these were used in the research credit computation. Request any instructions that accompanied the surveys/questionnaires.

Also, determine whether the taxpayer conducted interviews of current (and former) employees and contractors in order to formulate their determination. Advise the taxpayer that this information may need to be corroborated through supporting documentation, and additional interview procedures may be implemented for the examination.

A tour of all relevant company operations, including research facilities, should also be considered and arranged.

In planning the audit strategy, the Research Credit Technical Advisors are available to provide suggestions to effectively allocate audit resources to those issues that pose the greatest compliance risk.

3. RESEARCH CREDIT COMPUTATION

a. In General

The research credit is an incremental credit that equals 20 percent of a taxpayer's excess QREs (if any) for the taxable year over their base amount. The current carry-back is one year and carry-forward is 20 years (section 39). In many instances, verifying the base amount computation can have a more significant impact on audit results than the determination of allowable credit year QREs. Therefore, a review of the mechanical computation of the research credit is an essential step in the examination process, and should be performed in all examinations. All necessary documents, as determined during the pre-audit analysis, should be requested to insure that the taxpayer properly computed its research credit for all year(s) under examination.[4]

The scope and extent of the computation review may be influenced by the following non-exclusive factors:

- Proper determination of gross receipts, including prior audit adjustments made to gross receipts.
- A spike in the credit year's QREs relative to the base years.
- Acquisitions and/or dispositions of major portions of trades or businesses. I.R.C. § 41(f).
- Changes to the fixed-base percentage from prior years.
- Inconsistent treatment of expenses in the base years versus the credit years (e.g., the taxpayer claims that certain costs in the credit years are QREs, but has not treated those types of costs as QREs in the base years).

In general, for tax years beginning after December 31, 1989, the base amount is computed by multiplying the taxpayer's fixed-base percentage by its average annual gross receipts for the preceding four years. I.R.C. § 41(c)(1).

A taxpayer's fixed-base percentage is the percentage determined by taking aggregate QREs of the taxpayer for taxable years beginning after December 31, 1983, and before January 1, 1989 over aggregate gross receipts of the taxpayer for the same such taxable years. I.R.C. § 41(c)(3)(A).

The maximum fixed-base percentage is 16 percent. I.R.C. § 41(c)(3)(C).

[4] The Research Credit Technical Advisors' website contains a base computation workbook for use in computing changes to the base amount.

In no event may the base amount be less than 50 percent of the QREs for the credit year. I.R.C. § 41(c)(2).

Acquisition or dispositions of trades or businesses should be identified and verified (from the base years to the current year) to confirm that they are properly reflected in the computation. I.R.C. § 41(f).

The credit year's QREs and the base years' QREs are determined based upon application of the law in effect for the current year under examination. Consistency between the credit year's and the base years' QREs are required. I.R.C. § 41(c)(5). Therefore, in addition to base year workpapers, the examiner should ascertain the existence and availability of books and records from the relevant base years in order to determine consistency.

There may be instances where the calculation of the credit was not properly made. For example, taxpayers using the regular (non-AIRC) computation method who experience years of high growth in their gross receipts and flat expenditures on qualified research may find that they no longer are eligible for the research credit under the regular computation rules, because the credit year's QREs do not exceed the base amount. The examiner should be alert to the possible inclusion of non-qualified expenses as QREs.

Another aggressive strategy is for taxpayers to understate their "base amount" by understating the "fixed base percentage" and/or by understating "gross receipts" in the prior four years. The examiner should also be alert to applying the computational rules properly and verifying that all gross receipts are identified and reported.

When taxpayers can no longer maintain or increase spending on qualified research relative to gross receipts, they often transition to the Alternative Incremental Research Credit ("AIRC").

b. The Alternative Incremental Research Credit (AIRC)

Starting with taxable years beginning after June 30, 1996, a taxpayer may elect to compute the research credit using the AIRC. I.R.C. § 41(c) (4). The election must be made on an original return and is binding on all subsequent years unless formally revoked (with the consent of the Commissioner). However new temporary regulation (TD 9205) now provides for an automatic consent to change this election, by simply completing the appropriate portion of Form 6765 on a timely filed original return for the year of the change. A taxpayer cannot elect or revoke an AIRC election on an amended return. An examiner has no authority to make this change or allow the election for the taxpayer during an examination. Treas. Reg. § 1.41-8. If properly elected, the AIRC equals the sum of:[5]

1. 2.65 percent of so much of the QREs for the taxable year as exceeds 1 percent of the taxpayer's average annual gross receipts for the preceding four years. However, this amount

[5] The Tax Relief Extension Act of 1999 amended section 41(c)(4)(A) by striking 1.65 percent and inserting 2.65 percent, by striking 2.2 percent and inserting 3.2 percent, and by striking 2.75 percent and inserting 3.75 percent. This change applies to taxable years beginning after June 30, 1999.

cannot exceed 1.5 percent of taxpayer's average annual gross receipts for the four preceding taxable years.

2. 3.2 percent of so much of the QREs for the taxable year as exceeds 1.5 percent of taxpayer's average annual gross receipts for the preceding four years. However, this amount cannot exceed 2 percent of taxpayer's average annual gross receipts for the four preceding taxable years.

3. 3.75 percent of so much of the taxpayer's QREs as exceeds 2 percent of such taxpayer's average annual gross receipts for the four preceding taxable years.

c. Start-Up Companies

A “start-up company” is generally defined as a company that did not have both gross receipts and QREs in at least three of the base period years, or the first taxable year in which there were both QREs and gross receipts began after December 31, 1983. (The second provision did not take effect until July 1, 1996). For a start-up company, I.R.C. § 41(c)(3)(B) assigns a fixed-base percentage of 3 percent. The 3 percent start-up rate continues each of the first five years beginning after 1993. In years 6 through 9, a statutory fraction of the ratio between aggregate QREs and aggregate gross receipts is used to determine the start-up’s fixed-base percentage. Only years in which the taxpayer has QREs are counted in this computation. See I.R.C. § 41(c)(3)(B)(ii) to determine the start-up’s fixed base percentage after its initial 5-year period.

Spun-off companies may or may not be considered start-up companies for purposes of computing the base amount. Their base year activities carry over with them. A taxpayer that is created as a result of a spin-off may refer to themselves as a start-up, but if it had the relevant base year QREs and gross receipts, then it will not be treated as a start-up company.

d. Gross Receipts

Section 41(c)(6) does not provide a definition of the term “gross receipts”, other than to provide that gross receipts for any taxable year are reduced by returns and allowances made during the taxable year. In the case of a foreign corporation, only gross receipts effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico (for amounts incurred after June 30, 1999), or any possession of the United States (same) are taken into account. As a result, a taxpayer may have included in gross receipts only the figure on Form 1120, line 1c. Treasury Regulation section 1.41-3(c)(1) provides that for purposes of section 41, gross receipts means the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from all its activities and from all sources (e.g., revenues derived from the sale of inventory before reduction for cost of goods sold) with the exception of the following items that are specifically excluded by Treasury Regulation section 1.41-3(c)(2):

- Returns or allowances.

- Receipts from the sale or exchange of capital assets, defined under section 1221.

- Repayments of loans or similar instruments.

- Receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business or the sale of property used in a trade or business as defined under section 1221(2).

- Amounts received with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the goods or service, and the taxpayer merely collects and remits the tax to the taxing authority.

- Amounts received by a taxpayer in a taxable year that precedes the first taxable year in which the taxpayer derives more than $25,000 in gross receipts other than investment income.

  Selected issues include:

  1) A foreign branch of a United States company should have its receipts included as part of the gross receipts computation.
  2) Gross receipts of the entities required to aggregate their expenditures under section 41(f)(1)(A) and (B) should be included regardless of whether the entity companies have QREs.
  3) Gross Receipts should not be reduced by cost of goods sold.
  4) Tax exempt interest and other tax exempt income should be included in the gross receipts computation.

The examiner should secure information to determine the taxpayer's average annual gross receipts for the preceding 4 years as well as the gross receipts relevant to the fixed-base percentage. A good starting point to verify income is line 11 of Form 1120, page 1, adding back the cost of goods sold. The amount on line 11 should be reduced for capital gain, sales taxes, and other excluded amounts per Treasury Regulation section 1.41-3(c)(2) reported in the line 11 amount. Verify that the correct definition of gross receipts was used, and applied consistently for the prior 4 years and the base years. Confirm incorporation of any prior audit adjustments to gross receipts, when applicable.

e. Special Rules

The Research Credit Technical Advisor Team has identified the following recurring computational issues:

(1) Aggregation Rules of Section 41(f)

The examiner should take steps to insure that the taxpayer has included all relevant members in its research credit computation. Section 41(f)(1) requires that all members of the same controlled group (greater than 50 percent control), and all trades or businesses under common control, be treated as a single taxpayer. Care should be taken to ensure that all members have been included, as the section 41 definition of control is broader than the definition for consolidated return groups.

In May 2005, the IRS issued new temporary and proposed regulations (TD 9205 and REG-134030-04) under section 41(f)(1). These regulations retain the computation of the group credit from the July 2003 proposed regulations (REG-133791-02) except for a slight modification of the start-up company rules. However, these temporary regulations make significant changes to the allocation of the group credit to the members of the group. The July 2003 proposed regulations replaced proposed regulations issued in January 2000.

The computation of the aggregate group research credit under these new temporary regulations is computed by treating all of the members of the group as a single taxpayer. The group credit is computed under either the regular method or the AIRC method, whichever method produces the greater group credit. The temporary regulations provide that the decision to use one method or the other will be made by the designated member or the group. The designated member is the member of the group that is allocated the greatest amount of the group credit. If the group, as a whole, meets the start-up company provisions of section 41(c)(3)(b), then the group is considered a start-up company. However, if any one member had gross receipts prior to December 31, 1983 and another member had QREs prior to December 31, 1983, then the group as a whole does not qualify for start-up company status. The group credit is then allocated to the individual members of the group, using whatever method yields that member the greatest credit, regardless of whether or not they use the same method used to compute the group credit. However, the allocation to the individual members cannot exceed 100% of the group credit.

These new temporary regulations are effective for taxable years ending on or after May 24, 2005. However, the temporary regulations also provides that for taxable years ending on or after December 29, 1999, taxpayers can use any reasonable method of computing and allocating the group credit, provided that the members of the group do not claim more than 100 percent of the group credit.

(2) Short Years

a) Short Credit Year

If a credit year is a short taxable year, then the average annual gross receipts of the taxpayer for the 4 prior taxable years used in determining the base amount under section 41(c)(1) must be modified by multiplying that amount by the number of months in the short taxable year and dividing the result by 12. Treas. Reg. § 1.41-3(b).

b) Short Taxable Year Preceding the Credit Year

If one or more of the four taxable years preceding the credit year is a short taxable year, then the gross receipts for such year are deemed to be equal to the gross receipts actually derived in that year multiplied by 12 and divided by the number of months in that year.

c) Short Taxable Year in Determining Fixed-Base Percentage

No adjustment is made on account of a short taxable year to the computation of a taxpayer's fixed-base percentage.

(3) Acquisitions/Dispositions

Section 41(f)(3) generally requires an adjustment to be made to the base amount in the case of the acquisition or disposition of a major portion of a trade or business. Therefore, the examiner must ascertain whether the taxpayer made any acquisitions or dispositions that could affect the research credit computation. Compare the prior years and question any large discrepancies.

Change in ownership of a business is discussed under section 41(f)(3). Acquisition of the stock of another company, or disposition of stock, standing alone, does not trigger application of section 41(f)(3). See I.R.C. § 41(f)(1).

(4) Partnership Issue

Section 41 requires that a taxpayer incur credit-eligible research expenditures "in carrying on" any "trade or business". Thus, two conditions must be satisfied to qualify for the credit. First, as under section 174, there must be a qualifying trade or business. Second, the expense must be incurred in carrying on that trade or business.

The "in carrying on" and "trade or business" tests for the research credit generally are the same as the test for the purposes of section 162. The expenses must relate to a particular trade or business of the taxpayer that is being carried on at the time the expenses are paid or incurred. Thus, expenses paid or incurred in connection with a trade or business within the meaning of section 174 are not necessarily paid or incurred in carrying on a trade or business for purposes of section 41.

As is the case with section 174, when a taxpayer contracts out research and intends to sell or license the results thereof, the section 41 trade or business requirement is not satisfied if the activity is merely a financing arrangement.

a) Application of Test at Partnership Level

Under section 162, it is well established that the determination of the existence of a trade or business with respect to a partnership must be made at the partnership level, without regard to the existing businesses of the corporate or individual partners. The research credit regulations generally follow the section 162 approach to the application of the trade or business requirement to a partnership. Thus, if a newly formed research partnership initially has no active trade or business, the "in carrying on" requirement generally bars eligibility for the research credit.

b) Special Exception for Qualifying Joint Ventures

The research credit regulations provide that an in-house research expense or contract research expense paid or incurred by a partnership other than in carrying on a trade or business of the partnership is eligible for the credit if certain conditions are met. The regulations do not require that all partners meet the "in carrying on" test, but do contain limits similar to those in section

168(h)(6) (relating to tax-exempt use property).

c) Expenditures Relating to a Startup Business

Special rules for startup ventures in applying the trade or business requirement are set forth in section 41(b)(4).

4. QUALIFIED RESEARCH EXPENSES ("QREs")

Section 41(b)(1) defines QREs as the sum of (1) "in-house research expenses" and (2) "contract research expenses".

Section 41(b)(2) defines in-house research expenses as:

(1) any "wages" paid or incurred to an employee for "qualified services" performed by such employee;
(2) any amount paid or incurred for "supplies" used in the conduct of "qualified research";
(3) under regulations prescribed by the Secretary, any amount paid or incurred to another person for the right to use computers in the conduct of qualified research.

Section 41(b)(3) defines "contract research expenses" as 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research. If an expense is not set forth in section 41(b), a taxpayer may not claim the expense as a QRE.

a. Wages

The first category of in-house research expenditures eligible for the research credit consists of amounts paid or incurred for wages. Wages paid to an employee constitute in-house research expenses only to the extent the wages were paid or incurred for "qualified services" performed by the employee. For purposes of section 41, the term "wages" means wages as defined in section 3401(a). This means all taxable wages as reported on Form W-2, including bonuses and stock option redemptions. It does not include amounts that are not subject to withholding, such as certain fringe benefits or non-taxed income, even if paid for research services performed by an employee.

Stock options that are exercised and then included in wages subject to withholding, may or may not be included as wages in the research credit computation.[6] The option is generally granted as compensation for work performed and is subject to withholding upon grant. In such situations, the type of work done will determine if the option spread (wage) is included in the computation. For example, if an option is granted in 1997 and exercised in 2003, you would look to see if the work performed in 1997 would qualify as a qualified service. If it would qualify, then the spread is included in wages in the year the option is exercised. In other words, look to the grant year to determine if it is a qualified service but include the spread amount in the computation in the year it is exercised.

[6] See Apple Computer, Inc. v. Commissioner, 98 T.C. 232 (1992), acq., 1992-2 C.B. 1 (rtf, 31kb). and Sun Microsystems v. Commissioner, T.C. Memo 1995-69, acq., 1997-2 C.B. 1 (rtf, 25kb) for treatment of stock options.

Section 41(b)(2)(B) identifies three types of qualified services:

(1) Engaging in qualified research,
(2) Directly supervising qualified research; or
(3) Directly supporting qualified research .

Treasury Regulation section 1.41-2(c) provides further guidance.

The term "engaging in qualified research" means the actual conduct of qualified research, as in the case of a scientist conducting laboratory experiments.

The term "direct supervision" means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a "qualified research scientist". Specific attention should be paid to individuals who do not "directly" supervise qualified research activities (i.e., management levels higher than first-line supervisors). In some cases, higher-level research managers may perform some qualified research or direct supervision of qualified research due to their technical background and expertise, but this is usually only a minor fraction of their overall work activities. In addition, companies generally have a certain number of employees that work within traditional "research" departments who do not perform qualified services.

The term "direct support" means services in the direct support of either persons engaging in the actual conduct of qualified research, or persons who are directly supervising persons engaging in the actual conduct of qualified research. This would include the services of a machinist for machining a part of an experimental model used in qualified research.[7] Direct support of research does not include general and administrative services, or other services only indirectly of benefit to research activities.[8] This is true whether general and administrative personnel are part of the research department or in a separate department.

Treasury Regulation section 1.41-2(d)(2) provides that if substantially all[9] of the services performed by an employee during the taxable year consist of qualified services, then the term "qualified services" means all of the services performed by the employee for the taxpayer during the taxable year. The 'substantially all' rule for wages is analyzed on an employee-by-employee basis, and, in general, is determined by multiplying total wages by the following fraction: Hours spent in the conduct of qualified services over total hours spent in the conduct of all services (sick leave, for

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7 Other examples of direct support of research would include the services of (1) a secretary typing reports describing laboratory results derived from qualified research; (2) a laboratory worker for cleaning equipment used in qualified research; and (3) a clerk for compiling research data. Treas. Reg. § 1.41-2(c)(3).

8 Services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support. Treas. Reg. § 1.41-2(c)(3).

9 The "substantially all" for wages differs from the "substantially all rule" for Process of Experimentation.

example, would not be included in the fraction). See Treasury Regulation section 1.41-2(d) for the methodology applicable to this rule. If the ratio is less than 80%, the actual amount of qualified services should be used

Identifying the employees whose wages are claimed as QREs and determining the services they perform is perhaps the most important phase of auditing the research credit. Payroll records, employee job descriptions, performance evaluations, calendars and appointment books are good sources of information. The goal is to determine what the employee did and how much time they spent doing it.

If the employee pool is large, and it is impractical to achieve complete coverage, consider using statistical sampling techniques. Audit resources should focus on those employees whose job descriptions suggest they are engaging in administrative, manufacturing, marketing, and other non-qualifying activities. When appropriate, interviews should be considered to supplement and corroborate information obtained from the review of existing records.

An important caveat: Determinations as to whether an employee is (or is not) engaged in qualified services, should not be based solely on job descriptions or titles. Credit eligibility is based solely upon what an employee actually does, or does not, do during a specific time period. It is important to note the technical and educational qualification of a researcher, but this is not conclusive evidence that the individual engaged (or did not engage) in the performance of qualified services.

b**.** Supplies

A taxpayer may claim the research credit for amounts it paid or incurred for supplies used in the conduct of qualified research. Section 41(b)(2)(C) defines the term "supply" to mean any tangible property other than (1) land or improvements to land, and (2) property of a character subject to the allowance for depreciation. For example, overhead, license fees and costs for leasing assets are not tangible property and, therefore, not supplies. Supplies are used in the conduct of qualified research if they are used in the performance of "qualified services" by an employee of the taxpayer (or person acting in the capacity of an employee). To be a QRE, a supply must be directly related to the performance of "qualified services". Expenses for property used in general and administrative activities are not QREs. Accordingly, for the purposes of section 41, a "supply" is non-depreciable tangible property acquired by the taxpayer that is used in the performance of "qualified services".[10]

The examiner should request that the taxpayer produce documents to support its claimed supply expense to ensure that the amount only includes non-depreciable tangible property acquired by the taxpayer that was used in the performance of "qualified services".

There has been a trend to include a myriad of non-qualified research related costs in the credit computation by claiming such costs are "supplies". When reviewing the supplies claimed as qualified, focus on the statutory and regulatory definition of supplies. For example, taxpayers often improperly treat as a supply expense, the general and administrative costs related to "self constructed" supplies.

[10] For more information on the definition of a supply, see Lockheed Martin Corp. v. United States, 87 A.F.T.R.2d, ¶ 2001-812 (Ct. Cl. 2001). The only exception to the general rule is for certain "extraordinary utilities" expenditures. See Treas. Reg. § 1.41-2(b)(2).

Additionally, the examiner should carefully scrutinize "prototype"[11] expenditures to determine whether the "prototype" is (or contains) property of a character subject to an allowance for depreciation. Other examples of costs that are not supply QREs are:

- travel, meals or entertainment
- telephone expenses of researchers
- relocation or rental/lease expense
- professional dues or royalty/license expenses substantial

Supply QREs, in general, should represent a small portion of total QREs. When supply QREs are substantial, you should be alerted to the possible inclusion of capital or other ineligible expenses being claimed as QREs.

c. Contract Research Expenses

A contract research expense is 65 percent of any expense paid or incurred in carrying on a trade or business to any person, other than an employee of the taxpayer, for the performance on behalf of the taxpayer of qualified research, or services which, if performed by employees of the taxpayer, would constitute qualified services within the meaning of section 41(b)(2)(B). Treas. Reg. § 1.41-2(e)(1). If any contract research expense is attributable to qualified research to be conducted after the close of the taxable year, it shall be treated as paid or incurred when the qualified research is conducted. I.R.C. § 41(b)(3)(B). Thus, prepaid research expenditures are not eligible for the credit until the services are performed.

- Examining contract research expenses is one of the most straightforward, yet most often overlooked, research credit issues. An important audit step is to request a list of all contracts, along with the dollar amount of the claimed contract research expense (by contract). From this list, select the contracts that should be requested and reviewed. When there are only a few material contracts, all the contracts should be requested. The contracts should be reviewed to determine whether all the above legal requirements have been met.

Assistance of local counsel can be helpful in securing these agreements, as well as assisting with their interpretation. If requested contracts are not provided, and the taxpayer fails to represent (preferably in writing) that such contracts do not exist, we recommend the use of summons. This will ensure that the examiner has had the opportunity to review all of the taxpayer's documentation, and if the case is unagreed, helps to ensure that no new documentation will be provided at an Appeals conference.

Treasury Regulation section 1.41-2(e) provides a three-part test for determining if the payment is for the performance of qualified research where a third party performs the research for the taxpayer. An expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement (usually in writing, but not required) that:

[11] Taxpayer labels are not controlling.

(i) is entered into prior to the performance of the qualified research,
(ii) provides that research be performed on behalf of the taxpayer, and
(iii) requires the taxpayer to bear the expense even if the research is not successful.

Qualified research is performed on behalf of the taxpayer if the taxpayer has a right to the research results. Qualified research can be performed on behalf of the taxpayer notwithstanding the fact that the taxpayer does not have exclusive rights to the results. Also, if the expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result, rather than the performance of research, and the payment is not a qualified contract research expense.

Under Treasury Regulation section 1.41-2(e), a contract research expense is 65 percent of any expense paid or incurred in carrying on a trade or business to any person other than an employee of the taxpayer for the performance on behalf of the taxpayer of (i) qualified research, or (ii) services which, if performed by employees of the taxpayer, would constitute qualified services within the meaning of section 41(b)(2)(B). Where the contract calls for services other than services described above, only 65 percent of the portion of the amount paid or incurred, that is attributable to the services described above is a contract research expense.

Sometimes the activities to be performed by the contractor are more clearly defined in contractually-referenced work orders or statements of work rather than the body of the main contract. Such documents should be secured and reviewed.

A service contract differs from a research contract in calculating what amounts will be allowable contract research expenses. For example, in a service contract, the vendor may be paid by the hour and the research is not specified. In this case, you must look at the work done. Only the amounts paid for qualified research work would be included in QREs (subject to the 65% limitation). In a research contract where there is an agreed fixed price amount to perform qualified research, the entire amount would be subject to the 65% limitation and included as a QRE.

5. QUALIFIED RESEARCH ACTIVITIES

a. In General

In order for an activity to qualify for the research credit, the taxpayer must show that it meets all the requirements as described in section 41(d). Under section 41(d), the term "qualified research" means research:

1. With respect to which expenditures may be treated as expenses under section 174, (also known as the section 174 test);
2. Which is undertaken for the purpose of discovering information which is technological in nature, (also known as the discovering technological information test);
3. The application of which is intended to be useful in the development of a new or improved business component of the taxpayer (also known as the business component test); and

4. Substantially all of the activities of which constitutes elements of a process of experimentation for a qualified purpose (also known as the process of experimentation test).

To be considered "qualified research", the taxpayer must be able to establish that the research activity being performed meets ALL four of the above tests.[12] These tests must be applied separately to each business component of the taxpayer. Activities listed in section 41(d)(4) are not qualified research. Infra.

(1). The Section 174 Test

In order to meet the section 174 test, the expenditure must (1) be incurred in connection with the taxpayer's trade or business, and (2) represent a research and development cost in the experimental or laboratory sense.

Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product.

Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents.

Section 174 treatment is allowed only to the extent that the amount is reasonable under the circumstances. Expenditures for land and depreciable property are not allowed under section 174, although in certain cases, depreciation may be treated as a section 174 expense. (Depreciation is not a QRE under section 41). Exploration expenditures do not qualify as section 174 expenses. Furthermore, the provisions of section 174 are not applicable to any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore, oil, gas, or other mineral. Refer to the regulations under section 174 for further explanation on specific expense disallowances.

Treasury Regulation section 1.174-2(a)(3) disallows section 174 treatment for certain activities, including:

i. The ordinary testing or inspection of materials or products for quality control;
ii. Efficiency surveys;
iii. Management studies;
iv. Consumer surveys;
v. Advertising or promotions;

[12] In the case of certain software developed for internal use, taxpayers must meet the requirements of an additional three-part "high threshold of innovation" test. See Prop. Treas. Reg. § 1.41-4(c)(6)(vi). See also the ANPRM relating to the section 41(d)(4)(E) internal use software exclusion.

vi. The acquisition of another's patent, model, production or process; or
vii. Research in connection with literary, historical, or similar projects.

Since section 41 is more restrictive than section 174, expenses allowable under section 174 will still have to meet the other requirements of section 41(b) and (d) to be a QRE. For example, patent procurement expenses generally qualify under section 174 but would not qualify under section 41.

(2). The Discovering Technological Information Test

Final regulations, issued in January 2004 (TD 9104),[13] mirror the 2001 proposed regulations with respect to the discovering technological information test. There is no "discovery" requirement under section 41 separate and apart from that already required under Treasury Regulation section 1.174-2(a)(1) (i.e., was the research undertaken to eliminate uncertainty concerning the development or improvement of a business component). The final regulations, like the proposed regulations, abandon the requirement that the research activities be undertaken to obtain knowledge that exceeds, expands or refines the common knowledge of skilled professionals in a particular field of science or engineering.

Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. 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.

In order to satisfy the technological in nature requirement for qualified research, the process of experimentation used to discover information must fundamentally rely on principles of the physical or biological sciences, engineering, or computer science. A taxpayer may employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science to satisfy this requirement.

The final regulations state that the issuance of a patent by the Patent and Trademark Office under 35 USC sections 51 is conclusive evidence that a taxpayer has discovered information that is technological in nature that is intended to eliminate uncertainty concerning the development or improvement of a business component. This is known as the "patent safe-harbor". Be aware that the issuance of a patent is not conclusive evidence of qualified research, as the taxpayer still has to meet all the other activity requirements of section 41(d). Examiners should note that the securing of a patent usually occurs some time after the actual research year(s).

(3). The Business Component Test

The taxpayer must intend to apply the information being discovered to develop a new or improved business component of the taxpayer. A business component is any product, process, computer software, technique, formula, or invention, which is to be held for sale, lease, license, or

[13] Final Regulations for the Definition of Qualified Research under section 41(d) (doc, 90kb), also in HTML (htm, 137kb) and Adobe (pdf, 65kb), T.D. 9104

used in a trade or business of the taxpayer. Often times, taxpayers group all research in one broad category and do not identify the specific business component to which the business relates. A taxpayer must be able to tie the research it is claiming for the credit to the relevant business component. The 'substantially all' test is applied at the business component level.

(4). The Process of Experimentation Test

The final research credit regulations provide rules on the "process of experimentation test", which requires that qualified research be research "substantially all of the activities of which constitute elements of a process of experimentation".

The final regulations clarify the requirement that a process of experimentation is 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. Examiners are encouraged to read the preamble to these regulations to get a better understanding of the changes made. A taxpayer may undertake a process of experimentation if there is no uncertainty concerning the taxpayer's capability or method of achieving the desired result, so long as the appropriate design of the desired result is uncertain as of the beginning of the taxpayer's research activities. 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.

The final regulations articulate the core elements of a process of experimentation. In addition to requiring that the research be undertaken for the purpose of discovering information that is technological in nature, the taxpayer must:

1. Identify the uncertainty regarding the development or improvement of a business component that is the object of the taxpayer's research activities;
2. Identify one or more alternatives intended to eliminate that uncertainty; and
3. Identify and conduct a process of evaluating the alternatives.

The key difference regarding "uncertainty" in sections 41 and 174 is that, under section 41, uncertainly must relate to a qualified purpose, and must be resolved through a 3-element process of experimentation, fundamentally relying on the principles of the hard sciences, engineering, or computer science. The regulations clarify that merely demonstrating that uncertainty has been eliminated is insufficient to satisfy the process of experimentation test. Focus upon developing facts necessary to determine whether the taxpayer's activities meet these requirements and the core elements.

The preamble to the final regulations states that because of the clarifications made, the readily discernible and applicable provision in the 2001 proposed regulations is no longer necessary, because those activities do not constitute a process of experimentation under the final regulations. Accordingly, examiners who properly applied the "readily discernible and applicable" rule as a basis for disallowing the research credit have made proper adjustments. In pending and future examinations, however, the readily discernible and applicable standard should not be applied to a taxpayer's activities.

In order for activities to constitute qualified research under section 41(d)(1), 80 percent or more of taxpayer's research activities, measured on a cost or other consistently applied reasonable basis (and without regard to Treasury Regulation section 1.41-2(d)(2)), must constitute elements of a process of experimentation for a qualified purpose. The regulations provide that, if this substantially all requirement is met, then the balance of the research activities may qualify, if the remaining balance meets the requirements of section 41(d)(1)(A) (with respect to which expenditures may be treated as expenses under section 174), and if they are not excluded activities under section 41(d)(4) (such as research after commercial production, adaptation or duplication of an existing business component, etc.).

Although the final regulations are effective for taxable years ending after December 31, 2003, the Service will not challenge return positions that are consistent with the final regulations. As these final regulations merely clarify the proposed regulations upon which taxpayers are already relying, the Service's administrative approach will follow these final rules for all open years.

The process of experimentation must be conducted for a "qualified purpose", i.e., it must relate to a new or improved function, performance, reliability, or quality of the business component. The process of experimentation is not for a qualified purpose if it relates to style, taste, cosmetic, or seasonal design factors. I.R.C. § 41(d)(3)(B). Accordingly, be alert to claimed QREs for research related to non-functional aspects of the business component.

b. Shrink Back

The requirements of section 41(d) are to be applied first at the level of the discrete business component, i.e., the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license, or used by the taxpayer in its trade or business.

If the requirements for credit eligibility are met at that first level, then some, or all, of the taxpayer's research activities are eligible for the credit. If all aspects of such requirements are not met at that level, the test applies at the most significant subset of elements of the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license. This "shrinking back" is to continue until either a subset of elements of the business component that satisfies the requirements is reached, or the most basic element of the business component is reached and such element fails to satisfy the test.

The burden is on the taxpayer to establish that all of the section 41(d)(1) requirements have been met. The examiner should issue an IDR requesting a list of each qualifying project or activity, along with a complete description of that activity or project as a starting point in the evaluation, including the business component to which each research activity relates. As with the evaluation of wages, interviews should be considered to supplement and corroborate information obtained from the review of existing records.

c. Exclusions

There are certain research activities that are specifically excluded from qualified research

under section 41(d)(4). It is critical to look at the underlying facts to see if the exclusions apply. Taxpayer labels are not controlling. The following activities are not qualified research:

1. Exclusion for Research after Commercial Production

Section 41(d) (4) states that qualified research does not include any research conducted after the beginning of commercial production. A business component is considered ready for commercial production when it is developed to the point where it is ready for use or meets the basic functional and economic requirements of the taxpayer. In some cases, there may be “product release” documents where all responsible managers sign off that the new product and or new production method is now released for production, which may be helpful in the application of this exclusion.

The following activities are deemed to occur after the commencement of commercial production:

a) Preproduction planning for a finished business component,

b) Tooling-up for production,

c) Trial production runs,

d) Troubleshooting involving detecting faults in production equipment or processes,

e) Accumulating data relating to production processes, and

f) Debugging flaws in a business component.

This per se list includes “debugging” activities, but not “correction of flaws”. Treasury Regulation section 1.41-4(c)(10), Examples 1 and 2, illustrate the application of the exclusion for research after commercial production.

2. Exclusion for Adaptation

This exclusion applies if the taxpayer's activities relate to adapting an existing business component to a particular customer's requirement or need. This exclusion does not apply merely because a business component is intended for a specific customer. A contractor’s adaptation of an existing business component to a taxpayer’s particular requirement or need is not qualified research.

Treasury Regulation section 1.41-4(c)(10), Examples 3-7, illustrates the application of the adaptation exclusion.

3. Exclusion for Duplication

This exclusion applies if the taxpayer reproduced an existing business component, in whole or in part, from a physical examination of the business component, plans, blueprints, detailed specifications, or publicly available information with respect to such component. This exclusion does

not apply merely because the taxpayer evaluates another's business component in the course of developing its own business component.

Treasury Regulation section 1.41-4(c)(10), Example 8, illustrates the application of the duplication exclusion.

4. Exclusion for Surveys, Studies, Research Relating to Management Functions

The following activities are excluded under this provision:

(a) Efficiency surveys;

(b) Management functions or techniques, including such items as preparation of financial data and analysis, development of employee training programs and management organization plans, and management-based changes in production processes (such as rearranging work stations on an assembly line);

(c) Market research, testing, or development (including advertising or promotions);

(d) Routine data collections; or

(e) Routine or ordinary testing or inspections for quality control.

Treasury Regulation section 41-4(c)(10), Example 9, illustrates the application of this exclusion.

Note that it is the activity which governs, not the intended end result. For example, the development of a new production process, which met all the tests for qualified research, would not be excluded simply because the activity was preceded by a management efficiency survey.

5. Exclusion for Internal-Use Software

This exclusion is beyond the scope of this ATG.

6. Exclusion for Foreign Research

Qualified research does not include any research conducted outside the United States, Puerto Rico, or any possession of the United States.[14] This exclusion applies to in-house, as well as contract research. The foreign research disallowance applies even if the research is done by American researchers, or performed for an American taxpayer.

7. Exclusion for Research in the Social Sciences, etc.

[14] Section 41(d)(4)(F) was modified by P.L. 106-170 section 502(c)(1) which added the Commonwealth of Puerto Rico and any possession of the United States for amounts paid or incurred after June 30, 1999. Prior to amendment, section 41(d)(4)(F) applied only to the United States.

Qualified research does not include research in the social sciences (including economics, business management, and behavioral sciences, arts, or humanities).

Treasury Regulation section 1.41-4(c)(10), Example 10, illustrates the application of this exclusion. Note that the process, not the end result, governs. The development of new formulation of artists' paint would not be excluded simply because it benefited the arts, while research into Van Gogh's life would be excluded under this rule.

8. Exclusion for Funded Research

The exclusion for "funded research" under section 41(d)(4)(H) provides that the credit shall not be available for qualified research to the extent funded by a contract, grant, or otherwise by another person (or governmental entity).

All agreements (not only research contracts) entered into between the taxpayer performing the research and other persons are to be considered in determining the extent to which the research is funded. As a result, the examiner should request a complete copy of all contracts (including modifications), agreements, letters of understanding or similar documents where funding is an issue. These contracts and similar documents will need to be reviewed to determine whether, and to what, extent the research is to be considered funded. A "fixed-price" contract, where the customer agrees to pay a set price for a deliverable, and a "cost-plus" contract, where the customer agrees to pay the actual costs incurred by the contractor in acquiring/constructing the deliverable plus an additional amount for profit, are examples of the different contracts you may encounter. Counsel can be helpful in securing and interpreting these agreements. In the case of documents that are "classified" by a government agency, contact the Classified Contract Technical Advisor or a Research Credit Technical Advisor for further assistance.

In order to determine if the contractor's research expenditures are "funded", you must resolve the following issues:

- Is payment for the contractor's research activities "contingent upon the success of the research" under Treasury Regulation section 1.41-4A(d)(1)?

- Does the contractor retain "substantial rights" in the results of the research activities within the meaning of Treasury Regulation section 1.41-4A(d)(2)?

If the answer to either question is no, then the research is treated as funded. Amounts payable under any agreements that are contingent on the success of the research (thus considered to be paid for the product or result of the research) are treated as funded research. If a contractor retains substantial rights in the results of the research, and if payment to him is contingent on the success of the research, then the contract is not funded and the contractor is eligible to claim the credit.

Note that, if the contractor performing research for another person does not retain substantial rights in the research, and if the research payments are contingent on the contractor's success, neither the contractor nor the person paying for the research is eligible to claim the credit.

If a taxpayer performing qualified research for another person retains substantial rights in the research under the agreement providing for the research, the research is funded to the extent of the payments (and fair market value of any property) to which the taxpayer becomes entitled by performing the research. A taxpayer does not retain substantial rights in the research if the taxpayer must pay for the right to use the results of the research.

Frequently, taxpayers make some sort of funding allocation between "qualified research" and "non-qualified research" expenditures incurred in certain types of contracts, e.g., cost-share or cost overrun situations. In so doing, taxpayers often overlook the "pro rata allocation" requirements of Treasury Regulation section 1.41-4A(d)(3)(ii).

The general rule is that funding is to be allocated 100 percent to otherwise qualified research expenses (as provided by Treasury Regulation section 1.41-4A(d)(3)(i)) unless the taxpayer can meet the pro rata allocation requirements of Treasury Regulation section 1.41-4A(d)(3)(ii).

Pursuant to Treasury Regulation section 1.41-4A(d)(3)(ii), the taxpayer may allocate funding pro rata to nonqualified, and otherwise qualified research expenses, rather than allocating it 100 percent to otherwise qualified research expenses, if the taxpayer can establish to the satisfaction of the Service:

A) the total amount of research expenses,

B) that the total amount of research expenses exceed the funding, and

C) that the otherwise qualified research expenses (that is, the expenses that would be qualified research expenses if there were no funding) exceed 65 percent of the funding.

In no event, however, shall less than 65 percent of the funding be applied against the otherwise qualified research expenses. Material adjustments may be warranted if the specific requirements of Treasury Regulation section 1.41-4A(d)(3)(ii) have not been met.

Funding is determinable only in the subsequent taxable year. Treasury Regulation section 1.41-4A(d)(5) states that if, at the time the taxpayer files its return for a taxable year, it is impossible to determine to what extent particular research performed by the taxpayer during the year may be funded, then the taxpayer shall treat the research as completely funded for purposes of completing that return. When the amount of funding is finally determined, the taxpayer should amend the return and any interim returns to reflect the proper amount of funding.

6. THE CONSISTENCY REQUIREMENT

Section 41(c)(5)(A) provides that the QREs and gross receipts taken into account in computing the fixed-base percentage must be determined on a basis which is consistent with the determination of qualified research expenses for the credit year, regardless of whether the period for filing a claim for credit or refund has expired for any taxable year that is taken into account in determining the fixed-base percentage. To satisfy this consistency requirement, the taxpayer must show consistency between the QREs in the credit year and its QREs during the base years, as well as consistency

between gross receipts in the base years and the prior four years' average. Thus, if an expense is not qualified in the current credit year, it must be removed from the base year expenses, without regard to the law in effect during the base years.

The consistency rule is designed to insure that there is an accurate determination of the relative increase in qualified research expenses over the amount "typically" spent by the taxpayer relative to its gross receipts. The increase will be accurately measured only if the taxpayer includes the same type of expenses in the credit computation for both the base years and the credit year. This rule would apply, for example, where the taxpayer has failed to include a particular type of expense in both the base years and credit year computations, thus distorting the true increase in qualified research expenses.[15]

If a taxpayer claims a certain type of expense is a QRE in the credit year that it never previously treated as a QRE, it must adjust its fixed base percentage to reflect similar expenses that were paid or incurred during the base years. The research credit is an incremental credit and, thus, the taxpayer must prove that there has been an increase qualified research expenses relative to the base period. It is imperative that taxpayer establish its base year expenses. Taxpayers may not rely upon extrapolation of recent years' data as their support for the fixed-base percentage computation. Thus, base year records should be analyzed to determine the proper amount of expenses. Since you are examining an open credit year, which requires consideration of the earlier years, the statute of limitations for the earlier years is not controlling.

Consider the following questions with respect to the consistency requirement:

- Is the fixed-base percentage (the ratio of 84-88 QREs to gross receipts) in the base years substantially lower than current research ratios? If so, why?
- Do past annual reports or 10Ks support the reported base years' QREs?
- If the research credit was claimed in prior years, were the same base years' attributes used? If not, why not?
- Was there a prior research credit examination? Did it cover one or more of the base years?

Exercise judgment (risk analysis) in examining base years' information. For example, if the taxpayer's base amount is subject to the "50 percent limitation" rule, an upward adjustment in the base years' research percentage (the fixed base percentage) might have little or no effect on audit results.

[15] For example, in a case decided under the prior "rolling base period" rules, Research, Inc. v. United States, 95-1 USTC ¶ 50,407 (D. Minn. 1995), the taxpayer was denied the research credit because it could not quantify the base period research expenses attributable to its "special system projects." The expenses associated with these special projects were included in the credit year and the taxpayer admitted that it incurred the same type of expenses in the base period. The taxpayer could not, however, determine the amount it incurred in the base period because it had destroyed the relevant documentation. The court disallowed the credit because the relative increase in qualified research expenses could not be measured without considering the expenses incurred during the base period for the same type of projects included in the credit year.

7. SUBSTANTIATION AND RECORDKEEPING

Under the final regulations, a taxpayer must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. See I.R.C. § 6001; Treas. Reg. § 1.6001-1. The taxpayer must clearly establish full compliance with all of the relevant statutory and regulatory requirements. Failure to maintain records in accordance with these rules is a basis for disallowing the credit.

The Service does not have to accept estimates of qualified research expenses if documentation exists to verify the actual amount of such expenses. As set forth above, taxpayers are required to keep records substantiating the amount of any reported, claimed, or affirmatively raised deductions or credits.

The courts will allow the use of an estimation method only where the taxpayer does not have contemporaneous records, and then only as long as the following two conditions are satisfied. First, the taxpayer must establish that it engaged in qualified research activities as defined in section 41(d). And second, the failure to maintain a proper system to capture relevant information cannot be an "inexactitude is of their own making". Estimation methods are permitted only in cases where the sole issue is the exact amount paid or incurred in the qualified research activity. Accordingly, taxpayers must have factual support for every assumption underlying their estimates to meet their burden of proof. [16]

At the commencement of the audit, a meeting should be held with the taxpayer to discuss what type of contemporaneous books and records are available to substantiate the research credit claimed. Contemporaneous books and records should form the basis of the examination, and should be requested, as needed, in examining the particular issues addressed in this audit techniques guide.

The initial IDRs should focus on broad issues relating to information that is usually readily available to the taxpayer. Some examples of requested items are:

- Taxpayer’s base amount and fixed base percentage calculations
- General info: chart of accounts, organization charts
- Acquisitions and dispositions from 1984 through the tax year under audit
- Accounting method: Are costs accumulated by department or by project?
- Activities: What are they, and why are they eligible for the R&E credit?
- Wages: Names, amounts, % of annual wages, departments, job titles & descriptions
- Supplies: Categories, how they tie in to general ledger, amounts by category
- Contracts: With whom, amounts, categories

It is recommended that the items listed in the IDR be requested via several “bite-sized” IDRs. Pre-determined IDR turnaround time should be established and enforced.

The following information is helpful in understanding the appropriation of company resources or details of research projects the taxpayer conducted during the examination year:

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a. Materials explaining research activities, including brochures, pamphlets, press releases, and other similar documents.

b. Submissions to management, the board of directors, review committees or other similar groups regarding research projects, activities, expenditures, and the research credit.

c. Documents prepared by, or on behalf of, internal audit, including quarterly and annual reports that refer in any manner to research activities.

d. Minutes, notes, or other similar recordings from budget, board of directors, managerial or other similar meetings concerning research activities.

e. Project authorizations, budgets, or work orders that initiates a research project.

f. The internal authorization policies for approving a research project.

g. Project summaries and/or progress reports and project meeting minutes.

h. Field and lab verification data/summary data.

i. Research credit studies conducted by outside consultants.

j. Papers, treatises, or other published documents regarding the taxpayer's research.

k. Complete copies of contracts (including all modifications), letter agreements, memoranda of understanding, or similar documents for research performed by, or on behalf of, a third party.

Credible oral testimony by individuals with personal knowledge of the issues may be helpful in evaluating and/or supplementing a taxpayer's contemporaneous documentation. Interviews may be necessary to gather new information, or to confirm, clarify or refute other documentary or testimonial evidence. The interviewee will often be a technical or supervisory person with specialized knowledge of the issue in question. If conducted effectively, the interview can be a very useful examination tool. However, careful preparation is essential.

It is strongly recommended that another IRS colleague assist you during the interview:

- as a observer to the interview,
- to take notes, freeing you to concentrate on the interviewee's responses and to formulate your next question,
- to pose overlooked questions, and
- to provide additional technical and/or administrative support.

Notice 2004-11, (published in the Internal Revenue Bulletin on February 9, 2004), permits the Internal Revenue Service, and Large and Mid-Size Business (LMSB) taxpayers to enter into research

credit recordkeeping agreements (RCRAs).[17] This new Research Credit Recordkeeping Agreement program will help alleviate many of the tedious recordkeeping issues that now plague the research credit issue by allowing both taxpayers and the Service to agree upfront what records are necessary to support a taxpayer's research credit claim. If the taxpayer keeps these records, then disallowance for lack of substantiation will generally not be an issue.

An RCRA applies to future years and, in this way, the taxpayer can take steps to ensure that its research is properly documented before it ever takes place. The best time to propose such an agreement would likely be upon completion of the current examination cycle. At that time, the examiner, CAS, and the taxpayer are in the best position to determine what taxpayer records are necessary. If the parties enter into such an agreement, the taxpayer will know what records need to be kept and maintained in order for the Service to effectively and efficiently audit the credit. This may require the taxpayer to create new records for future years that previously did not exist. In addition, it may be determined that records presently kept, may no longer be needed. Although such an agreement will not resolve other audit issues, such as whether the activities qualify under section 41(d), it should improve and expedite the audit process to the mutual benefit of the parties.

The use of expedited resolution procedures including Advanced Issue Resolution (AIR) and Pre-Filing Agreements (PFA) should be considered, where appropriate. The examiner should also consider issuing a Notice of Inadequate Records[18], pursuant to Treasury Regulation section 1.6001-1(d), if the taxpayer does not keep sufficient or adequate records to support the research credit claimed.

8. SAMPLING METHODOLOGIES

In certain cases, use of sampling methodologies may be a desirable examination tool. Sampling is quite often used in research credit cases for greater audit efficiency. In fact, sampling should be considered in a research credit case whenever excessive amounts of time or resources are anticipated in examining all of the taxpayer's expenses or projects.

On March 4, 2002, the Director, Field Specialists issued a Field Directive addressing the use of both statistical and judgment sampling techniques in examinations of research credit cases. This directive states that the preferred method is a valid statistical sample. This Field Directive is available on the web site. Although the Directive recognizes the use of sampling for the research credit issue, it should be noted that it addresses sampling techniques applied in a post-filing environment. The Directive does not authorize taxpayers to use this as a substantiation methodology in preparing their returns.

However, we are aware of instances where statistical sampling has been employed to determine eligibility of such items as qualified wages, supplies, or contract services in the preparation of a tax return or claim. The Service's position of the application of such method is as follows:

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[17] Notice 2004-11 Research Credit Recordkeeping Agreements (RCRA) (doc, 59kb)

[18] Letter 1022 (DO) Inadequate Records Notice Follow-up , Letter 978 (DO) Notice of Inadequate Records , Letter 979 (DO) Inadequate Record Notice

> Under Treasury Regulation § 1.41-4(d), a taxpayer claiming the research credit must retain records in sufficiently usable form and detail to substantiate that expenditures claimed are eligible for the credit. Guidance on record retention is set forth in Treasury Regulation § 1.6001-1. If statistical sampling methods are discovered as the basis for determining return preparation or Claim filing amounts, the validity of the statistical sample must be confirmed by a CAS. Also, the scope or depth of the examination is not limited to the statistical sample items. The proper nexus between qualified expenses and activities must be established. The examiner is still entitled to request and receive records that will sufficiently substantiate all expenses and activities to which the credit claim relates, even if it is outside of the records maintained for the sample itself.

When a sampling technique is contemplated, the examiner, along with a CAS, should meet with the taxpayer and design a sampling plan that will result in an acceptable number of items to examine. The formulation of questions, questionnaires, or surveys to be used should be customized to each taxpayer's specific circumstances. Specific sampling procedures should be thoroughly documented. While a judgment (non-statistical) sample will often require less examination work than a statistical sample, a judgment sample generally requires taxpayer assent as to how results the judgment sample results will be applied, while a valid statistical sample does not. Agreement between taxpayer and examiner should be negotiated in the early stage of the examination, and should generally be set forth in a closing agreement (Form 906), binding the parties to apply the results of the agreed-upon methodology. Local counsel can provide assistance in the formulation of closing agreements.

If agreement is not secured, the taxpayer and the Service may not be bound to adhere to the sample results. Thus, if a taxpayer initially agrees to the use of a non-statistical sampling methodology and later objects, absent a closing agreement, any adjustments based upon the judgment sampling methodology may not be sustainable in court. For this reason, it may be necessary to apply statistical sampling in cases where the parties cannot agree on an appropriate judgment sample or sampling methodology.

It is important to note that the use of such alternative sampling methodologies may be limited, as in the case where a taxpayer has filed a claim for refund that may be subject to Joint Committee Review. Therefore, it is critical that examination methods are carefully assessed and selected based on appropriateness to the type of activities, accounting systems and records maintained by the taxpayer on a case-by-case basis.

9. RESERVED

10. RESEARCH CREDIT ISSUES

a. Coordinated Issues

Currently, there are four research credit Coordinated Issue Papers ("CIPs"), available on the IRS.gov website:

(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.[19]

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).

[19] Directive on 280C: direction on the handling of Research Credit claims involving the election of the reduced credit under Section 280C(c)(3) (doc, 59kb)

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 appeal's level, the absence of a clear statement of the facts in the RAR enables the taxpayer to be the primary provider/interpreter of the facts.

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).

11. CONTACT INFORMATION

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