Claiming the R&D Tax Credit: IRS Rules, Substantiation of QRAs and QREs, Offsetting Payroll Tax, AMT Liabilities

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Today’s faculty features:

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Claiming the R&D Tax Credit: IRS Rules, Substantiation of QRAs and QREs, Offsetting Payroll Tax, AMT Liabilities

Kreig Mitchell JD LLM
Kreig Mitchell JD LLM

- Former attorney and appeals officer for IRS, tax director for two Fortune 500 companies and prior Big Four, R&D specialty firm, and private practice experience
- Has prepared and defended 100’s of R&D studies for nearly 20 years
- Authored numerous white papers and a book on the R&D credit
Outline

- The Section 41 R&D credit
- The Calculation
- Qualified Research Activities, Qualified Research Expenses, Gross Receipts
- Advanced Topics
- IRS Audits of R&D Tax Credits
The Section 41 R&D credit
About the R&D Credit

- Enacted in the 1980s
- Was a temporary tax credit, extended/lapsed every few years
- Made permanent in 2015
- Congressional changes every few years
- One of the largest remaining tax benefits available to taxpayers today
About the R&D Credit

- Taxpayers in just about every industry can potentially qualify.

Examples
- Bank that designed computer software
- Postal delivery company that designed a computer database
- Defense contractor who designed a jet airplane
- Tool and die shop that designed plastic molds
About the R&D Credit

- Examples (continued)
  - Boat manufacturer that designed boat hulls
  - Oil and gas company that tested a process to clean the pipes in its chemical plant
  - Engineering company that designed a method to decontaminate a groundwater plume, etc.
About the R&D Credit

• Examples (continued)
  ○ Treasury Regulation § 1.41-4 examples of qualifying research: painting process, manufacturing technique involving robotic equipment, shredding blade for food products, hood for a car engine, warehouse management software, web application software, phone switching software, a motorcycle carburetor, belts used in manufacturing equipment, rail cars, and a gasoline additive
About the R&D Credit

Purpose of the R&D Credit:

To incentivize innovation and spur economic growth
About the R&D Credit

- The credit has bipartisan support
- Favored by the public, generally
- Difficult for the IRS to administer
- U.S. Treasury preference for consumption tax
About the R&D Credit

The Rules:

- Section 41
- Sections 174, 280C, 38/39
- Regulations 1.41-1 et seq.
- Court cases
- Administrative guidance
- Non-precedential IRS publications
About the R&D Credit

The Ingredients:

● Profit (maybe)
● Qualified research activities
● Qualified research expenses (wages, contract, supply, computer rental costs)
● Gross receipts (maybe)
● Documentation
About the R&D Credit

The Ingredients:

- Profit (maybe)
- Qualified research activities
- Qualified research expenses (wages, contract, supply, computer rental costs)
- Gross receipts (maybe)
- Documentation
The Calculation
The R&D credit is not refundable; taxpayers can only offset tax due; the R&D credit is one of the General Business Credits; excess R&D credits carryforward 20 years.

R&D credits no longer limited by AMT for C corps; however, higher income business owners can have flow through R&D credits limited by AMT if they are from larger businesses.
About the R&D Credit

The Calculation:

\[ \Delta \times \% \]
About the R&D Credit

The Ingredients:
- Profit (maybe)
- Qualified research activities
- Qualified research expenses (wages, contract, supply, computer rental costs)
- Gross receipts (maybe)
- Documentation

We need these ingredients for the credit year and the base years.
The Calculation:

About the R&D Credit

What base years do you use?

Base Years

Current Year

Δ x %
About the R&D Credit

The Calculation: Base Years

1. Regular Method:
   a. Historic Company - 1984 to 1988 if gross receipts in 1982 or prior and QREs in 3 of 4 years
   b. Start-Up Company - rolling base period years starting the first 5 to 10 years after 1993 with gross receipts and QREs

2. Alternative Simplified Credit (ASC) Method - prior 3 years
About the R&D Credit

The Calculation:

**Base Years:**
- Historic - 1984 - 1988
- Start-up - 5 year period
- ASC - prior 3 years

\[ \Delta \times \% \]
About the R&D Credit

The Calculation:

Base Years:
- Historic - 1984 - 1988
- Start-up - 5 year period
- ASC - prior 3 years

Rule of Thumb: Use the method with the largest increase

Δ x %
About the R&D Credit

The Calculation:

Base Years:
Historic - 1984 - 1988
Start-up - 5 year period
ASC - prior 3 years

Rule of Thumb: Use the method with the largest increase

\[ \Delta \times \% \]

Factor in different percentage: 20% regular credit or 14%/6% ASC
About the R&D Credit

The Calculation:

Base Years:
Gross receipts are counted when using the regular method.

Gross Receipts

Base Years: Gross receipts are counted when using the regular method.

Gross Receipts and QREs

Current Year: Gross Receipts

Δ x %
About the R&D Credit

The Calculation (regular method):

Regular method only; the ASC does not factor in gross receipts.
About the R&D Credit

The Calculation:

aka fixed-base percentage
About the R&D Credit

The Calculation:

Maximum fixed base percentage = 16%
About the R&D Credit

The Calculation:

Maximum fixed base percentage = 16%

Rule of Thumb: Lower fixed-base percentage = larger R&D credit
About the R&D Credit

The Calculation:

R&D credits are larger if....

<table>
<thead>
<tr>
<th>Credit Year</th>
<th>Base Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>QREs</td>
<td>QREs</td>
</tr>
<tr>
<td>Gross Receipts (for prior 4 years)</td>
<td>Gross Receipts</td>
</tr>
</tbody>
</table>

R&D credits are larger if....
About the R&D Credit

The Calculation: The Base Limitation

- The regular credit is also subject to the base limitation; the ASC is not subject to this limitation.
- This limitation can reduce the amount of QREs that count for the current year; limited to 50% of the current year QREs.
- Compares the increase in QREs (i.e., current year QREs minus the base year QREs) to 50% of the current year QREs--allows the higher of these amounts.
About the R&D Credit

The Calculation: The Base Limitation

\[
\text{Regular Computation} = \text{Smaller of} \left\{ \frac{QREs}{\text{Average Base Period QREs}} - \frac{\text{Average Gross Receipts}}{\text{Average Gross Receipts for the Prior Four Years}} \right\}
\]

or

\[
\text{Base Amount Limitation} = \frac{QREs}{\text{Current Year}} \times 50\% \times 20\%
\]
About the R&D Credit

The Calculation: The Base Limitation

- If the base limitation applies and limits the credit, the work in identifying gross receipts, base period QREs, base period start date, etc. are moot
- One can simply compute the credit by taking current year QREs x 50%
About the R&D Credit

The Calculation: The Sec. 174 Addback & Reduced Research Tax Credit

- One of the four part tests (described later) is that the expense must be eligible to be expensed under Sec. 174
- Section 280C(c) - Cannot deduct wages under Sec. 174 to the extent you count them for the R&D credit -- so add back wages and increase taxable income
- Can elect reduced R&D credit election in lieu of adding back wages - reduce credit by 21% top corporate tax rate
About the R&D Credit

The Calculation: It’s an Estimate!

- The calculation is not simply adding up a list of receipts and deriving a total
- The calculation takes QREs, reduces them by various set percentages (80% substantially all rule, 65% limit on contract QREs), can reduce it by the 50% base amount limit, and multiplies the result by another percentage (20%, 14% or 6%), the result may even be reduced by another 21% for the reduce credit
The Ingredients:

- Profit (maybe)
- Qualified research activities
- Qualified research expenses (wages, contract, supply, computer rental costs)
- Gross receipts (maybe)
- Documentation

We need these ingredients for the credit year, the ASC base years, **AND** the regular credit base years.
Qualified Research Activities
Qualified Research Activities

Qualified research activities

- Four-part test
- Not excluded
## Qualified Research Activities

### Four Part Test

<table>
<thead>
<tr>
<th>Business Component Test</th>
<th>Technological Information Test</th>
</tr>
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<tbody>
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<td>The research be useful in the development of new or improved business components</td>
<td>The research be for the purpose of discovering technological information</td>
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<th>Section 174 Test</th>
<th>Process of Experimentation Test</th>
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<td>The expenses are research and experimental expenditures and can be expensed under I.R.C. § 174</td>
<td>The research involves elements of a process of experimentation</td>
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</tbody>
</table>
Qualified Research Activities

Four-Part Test: Business Component Test

- The research be useful in the development of new or improved business components
- The term “business components” is unique to the R&D credit
Qualified Research Activities

Four-Part Test: Business Component Test

- The term “business component” means any product, process, computer software, technique, formula, or invention which is to be—
  ○ held for sale, lease, or license, or
  ○ used by the taxpayer in a trade or business of the taxpayer.

- Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced).
Qualified Research Activities

Four-Part Test: Business Component Test

- The “product,” etc. does not have to be a tangible product
- The terms “product, process, computer software, technique, formula, or invention” are not defined in the Code, regulations, court cases, or administrative guidance
Qualified Research Activities

Four-Part Test: Business Component Test

- Specificity in identifying the business component is not required. See, e.g., *Siemer Milling Company v. Comm’r*, T.C. Memo. 2019-37 (noting that the taxpayer has been inconsistent in its description of business components to which each project relates, but concluding that the inconsistency was of no consequence); *Trinity Industries, Inc. v. United States*, 691 F. Supp. 2d 688 (N.D. Tex. 2010) (counting the entire project as the business component).
Qualified Research Activities

Four-Part Test: Business Component Test

- The “business component” is basically cost accounting
- It is a method of grouping QREs
- Shrink-back rule: shrink back to the narrowest subset of elements that satisfy the four-part test. Treas. Reg. § 1.41-4(b)(2)
- Example in Treas. Reg. § 1.41-4(b)(3): motorcycle engine builder modifies engine and develops a new carburetor
- Taxpayers *will not* have records that identify the business components with specificity
Qualified Research Activities

Four-Part Test

- The expenses are research and experimental expenditures and can be expensed under I.R.C. § 174; - Expenses in the laboratory sense; uncertainty as to design or capability for the design; See Treas. Reg. § 1.174-2

- The research be for the purpose of discovering technological information;

- The research involves elements of a process of experimentation.
Qualified Research Activities

Four-Part Test

- The expenses are research and experimental expenditures and can be expensed under I.R.C. § 174;
- The research be for the purpose of discovering technological information; New to the business, not new to the world; regulations clarified (66 Fed. Reg. 66362 removed T.D. 8930)
- The research involves elements of a process of experimentation.
Qualified Research Activities

Four-Part Test

- The expenses are research and experimental expenditures and can be expensed under I.R.C. § 174;
- The research be for the purpose of discovering technological information;
- The research involves elements of a process of experimentation. - Systematic trial and error process; resolves uncertainties as to the design or capability to design the business component.
Qualified Research Activities

Non-Qualifying Activities

- Relating to style, taste, cosmetic, or seasonal design factors;
- Beginning after the start of commercial production;
- For adapting an existing business component;
- For certain surveys and studies;
- To reproduce existing products;
- To develop certain internal-use software.
Qualified Research Activities

Non-Qualifying Activities

- Relating to style, taste, cosmetic, or seasonal design factors; - aesthetics
- Beginning after the start of commercial production;
- For adapting an existing business component;
- For certain surveys and studies;
- To reproduce existing products;
- To develop certain internal-use software.
Qualified Research Activities

Non-Qualifying Activities

- Relating to style, taste, cosmetic, or seasonal design factors;
- Beginning after the start of commercial production; research ends when commercially viable product;
- For adapting an existing business component;
- For certain surveys and studies;
- To reproduce existing products;
- To develop certain internal-use software.
Qualified Research Activities

Non-Qualifying Activities

- Relating to style, taste, cosmetic, or seasonal design factors;
- Beginning after the start of commercial production;
- For adapting an existing business component; *does not rise to a new business component*
- For certain surveys and studies;
- To reproduce existing products;
- To develop certain internal-use software.
Qualified Research Activities

Non-Qualifying Activities

- Relating to style, taste, cosmetic, or seasonal design factors;
- Beginning after the start of commercial production;
- For adapting an existing business component;
- For certain surveys and studies;
- To reproduce existing products; - reverse engineering
- To develop certain internal-use software.
Qualified Research Activities

Non-Qualifying Activities

- Relating to style, taste, cosmetic, or seasonal design factors;
- Beginning after the start of commercial production;
- For adapting an existing business component;
- For certain surveys and studies;
- To reproduce existing products;
- To develop certain internal-use software.

- high innovation threshold - 3 additional tests
Qualified Research Activities

Non-Qualifying Activities (Continued)

- Not conducted in the U.S. or one if its possessions;
- In the social sciences, art, or humanities (literary, historical, or similar projects); and
- For services considered funded by a third-party.
Qualified Research Activities

Non-Qualifying Activities (Continued)

- Not conducted in the U.S. or one of its possessions; researcher not physically present in the U.S.
- In the social sciences, art, or humanities (literary, historical, or similar projects); and
- For services considered funded by a third-party.
Qualified Research Activities

Non-Qualifying Activities (Continued)

- Not conducted in the U.S. or one if its possessions;
- In the social sciences, art, or humanities (literary, historical, or similar projects); and - e.g., research to write a book
- For services considered funded by a third-party.
Qualified Research Activities

Non-Qualifying Activities (Continued)

- Not conducted in the U.S. or one if its possessions;
- In the social sciences, art, or humanities (literary, historical, or similar projects); and
- For services considered funded by a third-party. - two tests

1. Taxpayer bears the financial risk of non-payment
2. Researcher retains substantial rights
Qualified Research Activities

Question: Okay, so what are Qualified Research Activities?

Answer: “Design” work
Qualified Research Activities

Design work that...

Resolves a technical uncertainty (question) about:

- a product or service
- process improvement
Qualified Research Activities

Examples

- Prototyping or destructive testing
- Engineering
- Modeling or calculations
- Exploring design concepts or alternatives
Qualified Research Activities

More Examples

- Manufacturing product lines/systems:
  - Design of manufacturing lines & conveyor systems
  - Setup and workflow
  - Custom manufacturing equipment
  - Custom manufacturing processes
Qualified Research Activities

More Examples

- Testing of new materials, supplies, chemicals, code, etc.
- Products and services that require customization
- Creating custom client-facing software
- Creating internal use software (assuming no off the shelf alternative)
- Coding websites, e-commerce websites, or equipment (excluding basic GUIs, etc.)
Qualified Research Activities

Innovation Failure

- What if the project fails?
- Could still qualify the same as if the innovation was successful or adopted
- If the failure was due to a technical limitation or obstacle, failure may show the research was qualified
Qualified Research Expenses
Qualified Research Expenses

Diagram:
- Taxpayer
  - Research Activity:
    - In-House
    - Contract
  - Research Expense:
    - Wage Expense
    - Supply Expense
    - Computer Rental Expense
    - Contract Expense
Qualified Research Expenses

Qualified Research Expense Buckets:

- Wages
- Supplies
- Contract Work
- Computer Rental Costs
Qualified Research Expenses

Largest Categories for Most Taxpayers:

- Wages - Largest
- Contract Work - Large
- Supplies - Can be Large for Some Taxpayers
- Computer Rental Costs - Small
Qualified Research Expenses

**Wage QREs**

- Form W-2 wages or self-employment income
- Paid to person who:
  - performs research activities
  - directly supports research or
  - directly supervises research
- Can be highly paid employees/owners
- Reasonable compensation rules apply
- Questions: CEOs, marketing personnel, admins
Qualified Research Expenses

Supply Cost QREs
Non-depreciable, tangible, property used, consumed, or destroyed during development
- Tied to project
- Rental equipment
- Cannot be inventory re-sold to customers
Qualified Research Expenses

Contract Cost QREs

- Research performed by contractors
- Examples: Outside engineering or consultants
- Limited to 65% of the expense
- Apply the funded research limitation, but in reverse (payor generally wants T&M & cost reimbursement contracts)
Qualified Research Expenses

Computer Rental Cost QREs

- Cannot own the computer itself
- AI software like IBM Watson or Microsoft AI
Gross Receipts
Gross Receipts

• Gross receipts used to compute credits using the regular method
• Gross receipts for the base period and the four years prior to the credit year
Gross Receipts

Gross Receipts Include

- income derived by the taxpayer from all of its activities and from all sources.
- It also includes revenues from the sale of inventory before reduction for the costs of goods sold.
Gross Receipts

Gross Receipts Do Not Include

- Returns and allowances,
- Sale and exchange of capital assets,
- Sale of assets not in the ordinary course of business

See other items in Treas. Reg. § 1.41-3(c)(2)
Gross Receipts

Gross Receipts Do Not Include (Continued)

- income earned by foreign corporations
- Intercompany transactions between controlled group members
Identify Gross Receipts

- Start with Box (c) on Line 1 and adding the amounts included in Lines 4 for dividends, 5 for interest, 6 for gross rents, 7 for gross royalties, and 10 for other income.
- Reduce by amounts from intercompany transactions and amounts earned by foreign corporations that are not ECI.
No Documentation, No Credit

- Project lists, summaries, & reports
- Time tracking
- Expense records
- Gross receipts
- Current & base period
Cost-Center, Project Accounting, Hybrid

● Cost-center approach:
  ○ Focus is on QREs by employee. Determine qualified percentage for the employee overall
  ○ E.g., Employee A was paid $100 in Year 1 x 50% of his time was for qualified research, so $50 of QREs
Cost-Center, Project Accounting, Hybrid

- Project-accounting approach:
  - Focus is on QREs by project and determining qualified percentage for the project
  - E.g., Project ABC was worked on by Employee A and Employee B and each employee spent 20 hours on the project, since each employee was paid $XXX per hour, the QREs by project were $XXX.
Cost-Center, Project Accounting, Hybrid

- Hybrid approach:
  - Focus is on QREs by project as in a project accounting approach, but estimates are used as in the cost-center approach
  - E.g., Project ABC was worked on by Employee A and estimate that Employee B and each employee spent 20 hours on the project, since each employee was paid $XXX per hour, the QREs by project were $XXX.
Cost-Center, Project Accounting, Hybrid

- Project accounting approach is favored by the IRS; however, most IRS agents do not grasp the difference between the different approaches.
- Common for IRS agents to question project accounting approach not realizing that the less accurate methods could have been used and those can be less accurate.
Cost-Center, Project Accounting, Hybrid

- Taxpayer should use the best method based on available records, etc.
- IRS then has the burden to propose alternative method, which its agents *never* do
- IRS agents simply cite cases saying that a credit is a matter of legislative grace and it is up to the taxpayer to establish qualification for the credit
Statistical Sampling

- Statistical sampling is a possibility
- Consider using when:
  - Significant number of qualifying projects
  - Detailed records exist, i.e., detailed timekeeping records
Statistical Sampling

- Statistical sampling often leads to incorrect results
- While not favored, a skilled interviewer can do a much better job using the cost-center method
Minimum Documentation

- Regardless of approach, QREs should be broken down and tallied by project
- Timesheet data or some record documenting a method for allocating time to projects is required
  - Workpaper, survey, recreated time log, etc.
- Project descriptions addressing the four-part test are needed
Advanced Topics
Advanced Topics

- Payroll offset
- Choice of entity
- Funded research
- Internal use software
Payroll Offset

- Compute the R&D credit for income tax purposes and report on Form 6765
- Make the election on a timely-filed income tax return
- Payroll credit available on the next quarter’s payroll tax return
- Report on the Form 941 by attaching a g Form 8974
Payroll Offset (Continued)

- Only offsets employer portion of social security tax
- Credit is limited to $250,000 each year
- Can be taken by some PEOs
- Cannot deduct payroll taxes for which credit is taken
Payroll Offset (Continued)

To qualify, the taxpayer must have:

- less than $5M in gross receipts for a tax year
  - for sole proprietors, include gross receipts from all Sch C businesses / controlled group rules
- had no gross receipts before the five-year period ending with the tax year
Advanced Topics

Choice of Entity

- Partnership - Good if highly paid owners who do design work (can include guaranteed payments)
- C corporation - Good if stock options (but look to grant year to see if qualified, then pick up in year exercised), bad if fringe benefits not subject to withholding
- S corporation - Usually last choice
Advanced Topics

Funded Research

● Party who does the research:
  ○ Contractor paying employee wages (i.e., the researcher) or
  ○ Business paying contractor fees (i.e., purchaser)
Funded Research

Financial risk of nonpayment

- Ask the hypothetical question as of the date the contract is entered into, assuming the researcher performs, does the researcher bear the financial risk of non-payment if the research was to fail?

Fairchild Inds. v. United States, 71 F.3d 868 (Fed. Cir. 1995), rev’g 30 Fed. Cl. 839 (1994);
Geosyntec Consultants, Inc. v. United States, 776 F.3d 1330 (11th Cir. 2015); Dynetics, Inc. v. United States, 121 Fed. Cl. 492 (2015)
Advanced Topics

Funded Research

Financial risk of nonpayment

- Fixed price, time and material (hourly), or cost reimbursement
- *Populous Holdings, Inc. v. Comm’r*, Docket No. 405-17
Advanced Topics

Funded Research

Retention of substantial rights in research results

- Only applies to the researcher
- Question as to what rights are substantial
- *Lockheed Martin Corp. v. United States*, 210 F.3d 1366 (Fed. Cir. 2000)
Advanced Topics

Internal Use Software

- New regulations
- High threshold of innovation tests:
  - There must be an economically significant reduction in cost or improvement in speed or other measurable improvement that is targeted by the project
  - The software must not be commercially available
  - There must be significant economic and technical risk that makes the recovery of the resources devoted to the project uncertain
IRS Audits for R&D Credits
IRS Audits for R&D Credits

What is New is Old

- LB&I vs. SB/SE
- Amended Returns
- Past focus: Substantiation only
- Current focus - Substantiation plus:
  - Service providers
  - Business component / process of experimentation
IRS Audits for R&D Credits

What to Expect

● Expect the IRS to challenge the credit

● Expect the IRS to raise unique arguments
  ○ In *Siemer Milling Company v. Commissioner*, T.C. Memo. 2019-37, the IRS argued that the research tax credit could not be taken for a project that spans several years. The court rejected the argument.

  ○ In *Populous Holdings v. Commissioner*, Docket No. 405-17 (2019), the IRS argued that an architect firm only sells drawings and therefore it does not qualify for the research tax credit. The court rejected the argument.
IRS Audits for R&D Credits

- In *Trinity Industries, Inc. v. United States*, 691 F. Supp. 2d 688 (N.D. Tex. 2010), the IRS argued that a project incorporating components from third parties could not qualify. The court rejected the argument.

- In *Suder v. Commissioner*, T.C. Memo. 2014-201, the IRS argued that a taxpayer with engineering know-how knows engineering and therefore cannot qualify for credit. The court rejected the argument.

- Expect the IRS audit to take more than a year to complete

- Expect a tour of the business, employee interviews, and multiple IDRs
Preparing for the audit:

○ Test the sensitivity of the R&D credit
  ■ Do decreases to the QREs impact the amount of the credit? If so, how big of changes to the QREs change the credit by a significant amount?
  ■ Does the base limit or ASC first or second year rules preclude a need to deal with the base period?

○ Are credit carryforward years at issue?
Preparing for the audit:

○ Do the wage QREs include amounts that may not be reasonable compensation, employees with non-R&D job titles, etc.

○ What method was used to compute the credit, project accounting, cost-center, or hybrid?

○ What records are available?
To-do’s for the audit:

○ Do sort or summarize QREs by project for the IRS

○ Do provide the IRS with a project list and help the IRS agent select an appropriate sample to examine

○ Do prepare any project write-ups, etc. that are needed

○ Do document (i.e., type out) IRS employee interviews and provide the IRS auditor with a copy of the interview notes
To-do’s for the audit:

○ Do provide a large volume of organized information; unlike some other tax issues, more is usually better when it comes to R&D credit audits

○ Do check in with a tax advisor who handles these audits to see what the latest challenges/issues are
Q&A