

## **Credit for Increasing Research Activities GAO Questions for Tax Practitioners and Taxpayers**

GAO's goals for the interviews with tax practitioners and taxpayers:

- Identify what aspects of making research credit claims (and supporting them in the course of audits) taxpayers and practitioners find the most burdensome;
  - Making claims: (1) Finding records for the base period years of 1984 through 1988; (2) Performing accurate allocations for employees' time for taxpayers who perform qualified research but where project accounting is not common practice in their industry; (3) Finding contemporaneous documentation.
  - Supporting claims on audit: (1) Tendency of IRS agents and engineers to apply superseded regulations; (2) Complete rejection of claims in the face of overwhelming evidence that the taxpayer has performed qualified R&D; (3) Lack of proportionality -- IRS makes the same demands of "mom-and-pop" operations as it does of Fortune 500 companies claiming the R&D credit; (4) IRS's engagement of MITRE consultants who have a strong bias against the qualification of any internal use software and routinely misinterpret and misapply the high threshold of innovation test.
- Obtain additional perspectives on complaints that IRS has raised regarding some practices of taxpayers making research credit claims;
  - A great many of IRS's complaints stem from firms that are conducting R&D credit studies on a contingent fee basis. We have, with a few exceptions, abandoned this practice due to uncertainties regarding the application of Circular 230 and whether the filing of an amended return is sufficient to assert the anticipation of "substantive review". One definite downside to IRS's continued disapproval of contingent fee arrangements is that smaller taxpayers, who cannot commit to fixed-fee arrangements or open budgets for the time required to determine and document their R&D credit claims, are increasingly finding that fee concerns impair their ability to engage outside consultants and claim the credit. The documentation and correct computation of the R&D credit is too complex for mid-sized and smaller companies that do not have the internal resources to perform the necessary tax work. We do not believe that all firms utilize contingent fee arrangements to maximize their fees -- rather, such arrangements simplify the decision-making process for taxpayers upfront, allowing them to commit to an R&D credit study without committing to spending a lot of money on a fixed fee or hourly arrangement.
  - IRS's continued assumption that all taxpayers claiming the R&D credit are aggressively claiming non-qualified activities and costs has greatly soured the dialogue on making this credit work in the future. This assumption is simply not true. This dialogue is not advanced when the IRS Commissioner calls the R&D credit his number one concern in domestic tax matters while at the same time calling for the credit to be made permanent.

- Solicit suggestions for changes to the law or to IRS/Treasury positions or practices that might reduce compliance and administrative costs to taxpayers and IRS or that would make the credit a more effective incentive for increasing private sector research spending.
  - This is an easy and yet impossible task. As currently structured, being nonrefundable, the credit only benefits enterprises operating at a profit. To make it an even more effective incentive for increased private sector research spending, the credit should be refundable to businesses who are not yet earning taxable income. Studies have shown that smaller, more entrepreneurial, taxpayers are more innovative and generate more jobs than larger taxpayers, yet, until they generate a profit, they receive no benefit from the R&D tax credit. In today's economy, a significant portion of innovation and advances in technology are coming from startup companies but they are limited in their ability to fund these activities during their start up years. There is no policy reason why a small startup software company should not receive the credit for developing new/improved software, while Microsoft receives millions in such subsidies every year. This disadvantages the smaller company vis-à-vis the larger taxpayer.
  - IRS should simply acknowledge that most taxpayers keep their records on a cost center basis as opposed to project accounting, and that there is no way to reconstruct project accounting on prior year amended R&D claims.
  - Obviously, the Section 41 requirement on using the arbitrary 1984-1988 "base years" to determine taxpayers' fixed base percentages represents an almost-insurmountable burden for those taxpayers claiming the research credit for the first time, either because they just learned of it, recently came into existence, or only recently became profitable. From a tax policy standpoint, we agree that an incremental credit is the fairest way to create incentives to increase R&D to keep US companies competitive. Adoption of a rolling base period consisting of more recent years would relieve this recordkeeping burden and improve compliance.
  - Requiring qualified wages to be subject to withholding under section 3401 unfairly penalizes businesses that rely on employee leasing or HR outsourcing, which are more prevalent in today's business environment. An alternative would be to define employee wages based on which entity has control of their activities in order to differentiate leased or outsourced employees from independent contractors or consultants.
  - The exclusion for research after commercial production is problematic because in the real world, R&D does not automatically stop at some fixed point in time when a new or improved product is launched. The regulations should be amended so that certain activities are not "deemed" to be after commercial production. Rather it should be fact based and continue to qualify continued R&D activities that commonly occur after the first production run. The regulations should also clarify that new

releases of software are new products and therefore constitute new research projects.

- The requirement that the 280C(c)(3) reduced credit election be made on an originally filed return creates a hardship for S corporations that have to amend state returns as a result of the addback of R&D expenses on a retroactive research credit claim. It can also have the unintended consequence of moving S Corp shareholders into AMT.

Background information on the scope of interviewee's experience and perspective:

- What role does your firm play in preparing research credit claims for taxpayers and assisting them during IRS audits of those claims?
  - RSM McGladrey performs R&D credit studies, reviews, tax return preparations, FAS 109 reviews, FIN 48 reviews, and audit defense/support for all types and sizes of clients. In addition, as part of RSM McGladrey's audit defense function, we regularly appear before the IRS Appeals function.
- Please describe the scope of your clientele (typical size of corporation; range of industries)
  - Most of our clients have annual revenues in the range of \$5 million to \$500 million.
  - We provide R&D services for companies in the manufacturing, software, engineering, biotechnology and food industries.
- Do you think your role is very similar to that played by other large tax practitioners?
  - We believe that our status as the largest middle market accounting and tax firm means that we represent a wider range of taxpayers. For this reason, we believe we have more perspective on the IRS's lack of proportionality in policing the R&D tax credit. The smallest of taxpayers are expected to comply with the documentation requirements that IRS imposes on the largest of taxpayers. This drastically reduces the effectiveness of the tax credit for smaller taxpayers, which is unfortunate, since this market segment contributes greatest to the country's jobs growth and innovation.

Amended Returns

A key concern of IRS is the extent to which taxpayers have used amended returns to claim refunds based on research credits that substantially exceed those claimed on original returns. IRS feels that these amended claims are often poorly supported and much more "aggressive" than claims made on original returns, in part, because accuracy-related penalties do not apply to refund claims. The commissioner has called for an expansion of these penalties to cover abusive refund claims. IRS staff also suggested that the lack of reserve requirements concerning aggressive positions on amended returns may be another reason for the expanded use of amended claims.

- What factors have led to the use of amended returns for substantial additional research credit claims, often for multiple years into the past?
  - Often the first multiple year "barrage" of amended tax returns represents the fact that the taxpayer has only now learned of the availability of the

credit, having previously been convinced that it was only available for "rocket science."

- Moreover, R&D tax credit documentation is labor intensive and requires a high level of expertise that many companies do not have internally, so they often miss qualifying activities such as manufacturing process improvements or incremental product improvements. It is our duty as tax advisors to our clients to point out the tax incentives that Congress intended for these activities and assist our clients in obtaining these tax incentives for all open tax years.
  - Thus, we are not surprised that IRS notes these amended returns as substantially increasing the amounts of credit claimed -- they are moving the taxpayers from zero to 60. The fact that this first claim is for several tax years merely reflects the fact that, for most taxpayers, there is a multiple-year "look back" period still available to be amended under the applicable periods of limitations for refund claims. Also, doing a research and development tax credit "study" on a multiple-year basis is often more cost-effective than a single year study.
- Is IRS correct in saying that these refund claims are open to abuse and that expanded penalty is the appropriate corrective?
    - Everything is open to abuse. We believe, however, that IRS is overreacting to complaints received in the LMSB division, and applying those complaints across the board to all taxpayers. There are some taxpayers that have taken aggressive positions, but that is primarily because they have been advised by one of the aggressive "boutique firms" that has recently entered the R&D business. Not all tax service providers should be painted with the same brush; in fact we are aware of some boutique firms that also play by the rules but are tainted by the activities of their more aggressive competitors. We have always played by the rules when advising clients on research credit matters. As the fifth largest accounting firm in the US, we take professional standards and providing prudent tax advice very seriously and have quality control processes in place to properly manage the risk to the Firm and to our clients.
    - Far from seeing abuse on the taxpayer side, we are increasingly frustrated by the IRS's apparent treatment of the R&D tax credit as a "tax shelter." By and large, our clients are simply trying to take advantage of a credit with which they were previously unfamiliar, and for which they often have strained recordkeeping facilities. We attempt to assist our clients with improving their recordkeeping, but in the face of abandoning an R&D credit claim when records are incomplete or making bona fide estimates/reconstructions, we will assist clients in making such bona fide estimates/reconstructions. IRS regularly makes the mistake that the only evidence acceptable is documentary evidence, rejecting all testimonial evidence as inherently biased. This is unreasonable. However, it is our belief that IRS, in such instances, evidences a "take us to court, then" attitude. In such instances, many taxpayers' last resort is a protest to the

Appeals function of IRS. Very few taxpayers can actually afford to take the Service to court, either in the Tax Court or in a local District Court.

### Recordkeeping

It appears that recordkeeping is a major source of contention between IRS and taxpayers. IRS complains of cases where taxpayers or their practitioners simply provide roomfuls of binders and folders with inadequate explanation of how the information contained therein supports the claims for the credit.

- What are the most significant recordkeeping issues from the taxpayers' perspective? What are the most significant complaints regarding current regulations or IRS practices?
  - Most taxpayers maintain their cost records (and R&D credit claims are based, almost entirely, on costs, not revenues) on "cost center" bases, not project accounting. Thus, amended returns are usually based on retrospective implementations of project accounting, or translations of cost accounting into some project basis. IRS refers to this as "hybrid" accounting. IRS apparently believes that all such retrospective accounting is inherently flawed and biased.
  - We have little complaints about IRS's current regulations regarding recordkeeping. However, Revenue Agents and their managers, together with IRS's four National Technical Advisers on the R&D credit often apply long-rejected proposed regulations in audits. Thus, we regularly see Examiners and Technical Advisers applying the "discovery test," (explicitly abandoned by IRS/Treasury in 2001) and the requirements that all R&D credit calculations be supported by "contemporaneous documentation" (also long-rejected). Thus, it is not the regulations that are at fault, but IRS's audit practices.
- Are you familiar with IRS' pilot Research Credit Recordkeeping Agreement (RCRA) program? Do you know why only a handful of taxpayers chose to participate? Do RCRA's have the potential to resolve a lot of the contention between IRS and taxpayers over recordkeeping? Will the fact that some taxpayers have entered these agreements put pressure on others to do so?
  - We are not surprised that only a handful of taxpayers chose to participate. It was not widely publicized and many taxpayers who were aware of it felt they were better off going to Appeals when their claims are rejected in examination.
- Is the lack of permanence of the credit a factor in terms of the extent to which taxpayers are willing to invest in specialized recordkeeping systems to support credit claims?
  - We believe that, yes, taxpayers are less likely to adopt specialized recordkeeping systems for a credit which regularly lapses into nonexistence. We also believe that the credit's impermanence and audit risk causes some otherwise-eligible taxpayers to forgo claiming the credit entirely.

### Qualified Research Expenditures

The most frequent issue that IRS appears to raise in audits of the research credit is the lack of support demonstrating that research spending meets the multiple qualifying tests (section 174 test; discovery test; business component test; process of experimentation test).

- Do the difficulties that taxpayers face in this area arise from 1) the way the tax code is written, 2) the way that Treasury/IRS have interpreted the tax code (in terms of either what tests must be met or what documentation must be provided to demonstrate that the tests have been met), or 3) the inherent difficulty of defining and identifying research spending that merits a government subsidy?
  - (1) The way the Code is written is not the issue. While the Code could be simpler, we have had sufficient experience with it since its enactment in 1981 to grasp its nuances. With the exception of two areas -- refundability of the credit and the insistence upon the 1984 through 1988 base years -- we would not make any suggestions to change the Code. (2) IRS's interpretations/applications of the Code are definitely problematic. IRS interprets the Code too narrowly, in a manner inconsistent with Congressional intent and the legislative history, and often insists upon documentation standards which are unreasonable. (3) No, the types of projects which qualify are usually readily apparent. However, in some instances, as where a taxpayer is simply redesigning/ reengineering a product to make it more economically (cheaper), we are aware of instances where the IRS unreasonably denied a credit under the theory that cost savings is not a permitted purpose for creditable R&D. We believe that cost savings is directly related to performance, which is a permitted purpose under the requirements of section 41(d)(3)(A).
  - It is also interesting to note that the question above refers to the "discovery test". The notion of a discovery test as brought forth in an earlier version of proposed regulations was eliminated in the section 41 final regulations. We believe the test under section 41(d)(1)(B) is more accurately referred to as the "technological in nature" test. The distinction being that the term "discovery test" implies obtaining knowledge that exceeds expands or refines the knowledge of skilled professionals in the field of science or engineering. The final regulations specifically state that discovery of this kind is not required in order to meet this test (this is also reflected in very clear legislative history). The test is only to intend to discover information that is "technological in nature" in order to develop a new or improved business component.
- What, if any, improvements can be made to current law, regulations, or IRS practices regarding the identification of qualified research expenses?
  - From what we have seen, not only Revenue Agents and their Managers, but also IRS's four National Technical Advisers on this credit need better and more frequent training. Sometimes, it is as simple as informing such IRS personnel that certain administrative tests -- the "discovery test" and "contemporaneous documentation" come most quickly to mind -- simply

no longer exist. Also, IRS needs to institute a concept of proportionality. Small taxpayers should not be audited the same way the largest of taxpayers are. An important example of this is the recently-implemented "IDR Q," which is prefabricated discovery being issued to all taxpayers (regardless of their size) in many audits. As an identical set of questions being posed by a government agency to more than five respondents, we believe that IDR Q probably violates the Paperwork Reduction Act. This, however, is not surprising, given IRS's decades-long disdain for all constraints on its regulatory rulemaking abilities -- the Regulatory Flexibility Act, the SBREFA, and the Paperwork Production Act, to name a few. We understand that this was recently the subject of comments by SBA's Office of Advocacy.

#### Administration of the Credit

The following issues also appear to have been subjects of disagreement between Treasury/IRS and taxpayers or their representatives:

- The method for allocating credits among members of a controlled group;
  - We believe the current set of regulations are a fair method of allocating the credit among members of a controlled group.
  - The definition of controlled group is complex and presents significant uncertainty and complexity in administering the credit.
- The extent to which expenditures for internal use software qualify for the credit;
  - This is absolutely a contentious area and one in which we believe the IRS has gone too far in disallowing legitimate qualified research. We recently re-examined this issue in light of our defense of one of our largest clients. The IRS technical coordinator assigned to this case showed a surprising lack of knowledge of even the most basic exceptions to the definition of internal use software. It is our belief that the Internal Use Software rules, if they are ever implemented by regulation, should be limited to internal software used in staff functions such as accounting, human resources, legal, marketing and the like. Software that is used in sales or service to customers is constantly being developed and improved in order to give businesses a competitive advantage. Some industries, like financial services and retail rely heavily on software for the way they serve customers. Further, IRS's use of MITRE consultants seems to be heavy-handed. IRS takes whatever engineer is tasked to them by MITRE, regardless of that engineer's professional qualifications (or lack thereof). These engineers from MITRE are often ill-educated in the tax laws (we assume by the IRS), and their opinions are consequently biased and inaccurate.
- The definition of gross receipts for purposes of computing the credit;
  - No, we have not noted any particular problem in the definition of "gross receipts."
- The consistency in definitions used for base period and current research expenditures;

- No, both taxpayers and the IRS know the consistency rules and we believe it is good tax policy if administered reasonably. Often, however, given the lack of records for 1984 through 1988, base, calculations are extremely difficult to perform. This is an inherent flaw of the current Code.
- Issues relating to partnerships and S corporations;
  - Partnerships and S corporations are frequently smaller taxpayers, and our concerns about IRS proportionality in examination are often most apparent in our partnership and S corporation clients.
  - The definition of controlled group causes problems when minority shareholders are impacted by conditions in another group member in which they have no knowledge or involvement.
- Issues relating to taxpayers' use of sampling when estimating qualified research expenditures.
  - Sampling is a necessity when attempting to calculate R&D credits in a way that is economical for taxpayers. When a taxpayer learns of the availability of the R&D credit, and the possibility that it may be available for already-filed tax years, some way of gathering information for older tax years must be devised. In addition, the sheer number of projects may make it economically prohibitive to document the qualified research activities of every single project. Sampling is often the only rational answer. Both taxpayers and the IRS know that sampling needs to be rational, and unbiased. However, the means of getting to those ends often diverge greatly.

Are there significant aspects of any of these issues that remain inadequately resolved by the latest regulations? Can you suggest any resolutions for them? Are there any other issues of contention or sources of burden for taxpayers that we have not identified above?

- We believe the above responses cover the areas that we see room for improvement

#### Pre-Filing Agreement Program

Are you familiar with IRS' Pre-Filing Agreement Program? To what extent can PFAs help taxpayers avoid costs associated with audits of the research credit? Why don't more taxpayers make use of PFAs with respect to their methodologies for computing their qualified research expenditures?

We are familiar with the PFA program, but have not used it extensively in our practice, primarily because many of our smaller clients cannot afford to re-do their record-keeping for this one credit. However, were the IRS to suggest, as an audit strategy, a more collaborative process for taxpayers in return for PFA participation, we would certainly consider this. Please note, this is usually not a situation where a taxpayer has no evidence for its R&D credit amount claimed, but is rather IRS's preference for certain kinds of records/evidence over others. Thus, even if an IRS agent is presented with a knowledgeable witness, with a good recollection of who was doing what regarding a taxpayer's R&D activities, the IRS almost without exception will reject that witness's evidence if it is not backed up with some kind of contemporaneous documentation.

## Design of Credit

Regarding the design of the credit and the various options available to taxpayers:

- Is the choice of which credit to elect always clear-cut and based on the relative size of the benefit generated by each option, or are there other things to consider, such as recordkeeping burdens? Do these considerations vary much by type of taxpayer?
  - Usually the decision as to what options to elect vis-à-vis the credit is made on several variables: (1) are certain elections available to the taxpayer or, because the returns are being filed on an amended basis, are these elections foreclosed?; (2) what options vis-à-vis the credit produce the maximum benefit for the taxpayer?; (3) Will it be possible for the taxpayer to uncover/generate records from 1984 through 1988 to use the traditional fixed base percentage method of calculating the credit?
  - In some instances, taxpayers, when faced with doing historical research into the years 1984 through 1988, often "punt" and take the position that they had no QREs in the earlier years, choosing to be treated as "startup" taxpayers.
- Would there be any significant transition issues to deal with if Congress were to eliminate 2 of the 3 current credit options and make only the new alternative simplified credit available?
  - We believe the greatest obstacle to this would be from traditional manufacturing companies who have institutionalized this method of calculating the credit and are likely to have a larger benefit under the traditional method.
- On what factors is the 280c election normally based?
  - Interestingly, the 280C(c)(3) election normally reflects practical (concerns with fees and undue paperwork) concerns rather than tax concerns. Making this election usually means less paperwork for taxpayers with respect to state tax returns. For pass-through entities, it usually means fewer adjustments for their owners. We believe it is unfortunate that this election is not available on amended returns, as this penalizes taxpayers who were previously unaware of the availability of the credit.
  - The other common factor is a better state tax result in states that base their taxable income on federal taxable income as a starting point.