Internal Revenue Service
Large & Mid-Size Business Division
Office of Pre-Filing & Technical Guidance
Research Credit Technical Advisor Program

Briefing Paper on Taxpayer Approaches to Capturing Costs for the Research Credit

Summary

This paper presents an overview of the cost capturing approaches that examiners most widely encounter in examining the Research Credit, IRC Section 41[1]. Potential problems with an approach commonly associated with "prepackaged submissions" is discussed as is a recommended course of action for applying the direction contained in the Research Credit Technical Advisor team's Audit Techniques Guide.

Introduction

On October 12, 1995, the Research Credit Technical Advisor (then known as the Research Credit Issue Specialist) released to the field an audit plan for the Credit for Increasing Research Activities under Section 41 of the Internal Revenue Code (research credit). The plan discussed the two predominate approaches used by taxpayers to capture costs attributable to the research credit; the project approach and the cost center approach. Subsequent to the publication of the audit plan, the Internal Revenue Service (IRS) has received numerous returns and claims for refund based on the purported application of the cost center approach. Upon audit, IRS examiners have found these claims to follow a hybrid approach that is very different from the cost center approach as discussed in the audit plan.

Internal Revenue Code Section 446 provides the general rule under which a taxpayer is to maintain its books and records. The language is of necessity broad to permit the unique accounting issues that may confront various industries. In general, most large corporations are required either by virtue of government regulation or at the insistence of their lenders, to maintain their books and records in conformity with Generally Accepted Accounting Principles (GAAP). Neither Sections 174 nor 41 contain any specific requirement that a taxpayer capture the costs of its research under a particular approach. Thus, taxpayers may capture their research costs using any approach appropriate to their system of books and records so long as the results are auditable. The purpose of this paper is not to specify a preference for any one cost capturing approach, but to illustrate by way of comparison with other commonly used approaches

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

a problem with the hybrid approach as it is encountered by IRS examiners that makes it unauditable.

The 1995 Research Credit Audit Plan

The research credit computation is founded on a taxpayer's expenditures for activities that constitute qualified research as defined in the statute. Thus, to obtain the credit, a taxpayer must have some approach to identify activities as qualified research and capture their associated cost. A taxpayer's financial accounting records contain information on costs but rarely contain information that relates those costs to an activity or a business component. Thus, the task of providing the records to support the research credit generally falls to the taxpayer's cost (also referred to as managerial) accounting system.

There are two predominate approaches to maintaining managerial accounting records to record costs – the project (also referred to as "job cost") approach and the cost center (also referred to as "departmental") approach. In drafting the 1995 audit plan, the existence of these two approaches was recognized and guidance was provided on how to examine them. The two approaches are illustrated below.

The Project Approach

The project (which may also be referred to as the "job cost") approach is grounded in the matching principle of accounting. The project approach directly matches costs with the activities that gave rise to them. As all costs associated with an activity are gathered together by the accounting system, qualified activities can be readily determined and matched to the costs associated with them. The relationship between costs and activities in this approach is illustrated below:

Project		
Cost associated with Project A	———	Activities associated with Project A
Cost associated with Project B	———	Activities associated with Project B
Cost associated with Project C	———	Activities associated with Project C
Cost associated with Project D	———	Activities associated with Project D
Cost associated with Project E	———	Activities associated with Project E

Table 1 - Illustration of the Project Approach

Once it has been determined that the taxpayer's accounting system has sufficient integrity to properly assign costs to the associated projects, examination of costs accumulated using this approach is fairly straight-forward. The expenses are reviewed to determine whether they are qualified research expenses as defined in Section 41(b). The activities are reviewed to determine whether they meet the requirements for qualified research as defined in Section 41(d).

The Cost Center Approach

The cost center (which may also be referred to as the "departmental") approach is a logical grouping of activities that often follows the organizational structure of the company. The cost center approach tracks costs based on where within the company structure the cost was incurred. As illustrated below, a cost center may contain:

- The activities on a single business component (in which case this approach does not differ significantly from the Project method),
- The activities on numerous business components (which may be related to one another), or
- The activities associated with only a portion of a particular business component.

Cost Center	
Costs within Cost Center A	Activities associated with Business Component Z
	Activities associated with Business Component Y
	Activities associated with Business Component X
Costs within Cost Center B	Activities associated with Business Component W
	Activities associated with Business Component V
	Activities associated with Business Component U
Costs within Cost Center C	Activities associated with Business Component T
Costs within Cost Center D	Mechanical design associated with Business Component S
Costs within Cost Center E	Electrical design associated with Business Component S
Costs within Cost Center F	Mechanical design associated with Business Component R
	Mechanical design associated with Business Component Q
Costs within Cost Center G	Electrical design associated with Business Component R
	Electrical design associated with Business Component Q

Table 2 - Illustration of the Cost Center Approach

Although there is not necessarily a direct relationship between particular costs and activities within a cost center system (so that taxpayers applying this approach instead of the project approach face the burden of establishing that the activities undertaken within each of the cost centers are qualified research), each cost center does represent a limited pool of costs and activities that are related to one another in some way.

Once it has been determined that the taxpayer's accounting system has sufficient integrity to properly assign costs to the correct cost center, examination of costs accumulated using this approach is fairly straight-forward. The expenses are reviewed to determine whether they are qualified research expenses as defined in Section 41(b). The activities are reviewed to determine whether they meet the requirements for qualified research as defined in Section 41(d).

In those situations where the costs charged to the cost center represent activities on more than one business component, a taxpayer employing the cost center approach will face the additional burden of segregating costs that do not qualify. If the research credit computed under a cost center approach is audited and the examiner determines that non-qualified activities were charged to a cost center that the Taxpayer had considered to be composed entirely of qualified costs and activities, the Taxpayer will face the challenge of allocating costs among the activities within the cost center.

In those situations where the costs charged to the cost center represent only a portion of the activities related to a particular business component, a taxpayer employing the cost center approach may face the additional burden of associating the activities of several cost centers with the business component in order to demonstrate that the activities are qualified research.

The additional burden the taxpayer faces in computing the Research Credit under this approach partially offsets the savings that can be realized from the simplicity of implementing and administering it.

The Hybrid Approach

Subsequent to the publication of the Research Credit audit plan, IRS examiners began encountering refund claims prepared as "prepackaged submissions" that were computed using a hybrid approach to cost capturing that is an amalgamation of the Project and Cost Center approaches. This hybrid method may be presented as a cost center approach since the costs are accumulated from departments within the company. It is also common for taxpayers using the hybrid approach to assert that they do not have a project accounting system in place and that this necessitated the adoption of a cost capturing approach based on the use of cost centers. The hybrid approach adopts those portions of each approach for which records are most easily obtained, often without regard to the relationship those records have to particular activities or costs.

In the hybrid approach costs are captured on a cost center (departmental basis). Typically, this cost is the summation of the W-2 wages of employees assigned to that department adjusted to account for time spent on activities that are not qualified research. The adjustment is usually made by applying a percentage to the W-2 wages. The source of the percentage is generally management's after-the-fact opinion as to the amount of time that particular classes of employees spent doing qualified research. Since the "cost centers" used in the hybrid approach are departments within the taxpayer's organizational structure, they may not bear any relationship to the cost centers used in the taxpayer's managerial accounting system.

In the hybrid approach, activities are identified and documented on a project basis. As the taxpayer employing this approach has typically represented that they have no project accounting system, the project names can be expected to bear no relationship to any existing taxpayer records. The relationship between costs and activities as determined by this approach is illustrated below:

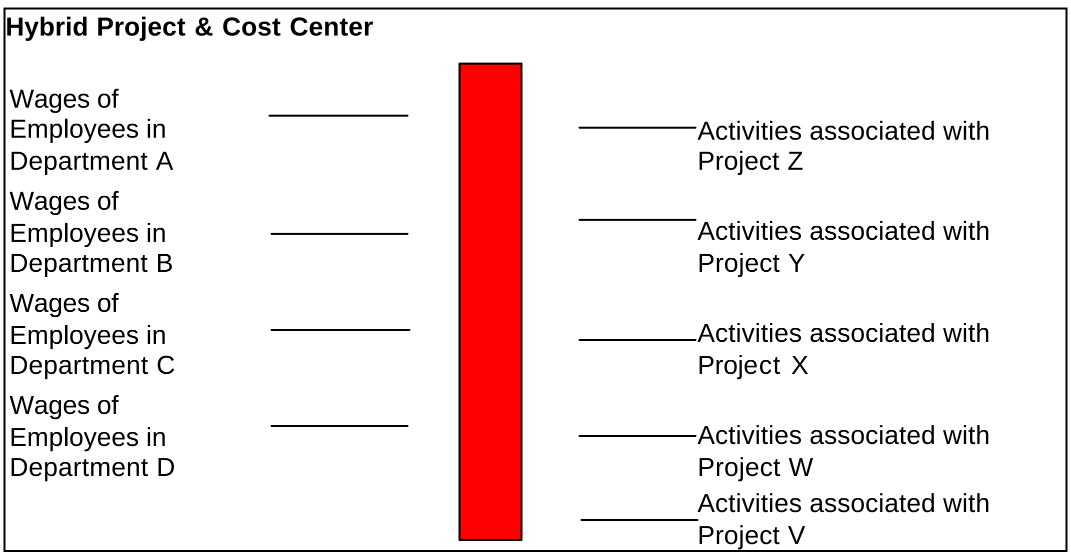

Table 3 - Illustration of the Hybrid Approach

The costs captured under the hybrid approach are generally based on the opinions of company managers delivered years after the fact. Contemporaneous records are rarely available to support these opinions. These are significant problems, but they relate to the factual development of the case. As seen in the illustration, the hybrid approach faces an insurmountable theoretical problem as it lacks a nexus between purportedly qualified activities and the allegedly associated costs. Because of this, examination of the claimed credit computed using this approach is almost impossible regardless of the integrity of the taxpayer's accounting system. In other words, if the IRS were to accept the qualification of each of the taxpayer's numerous activities except for one, how would the dollar amount of the proposed adjustment be computed? With the hybrid approach, it is generally not possible to directly compute the adjustment – the best that could be obtained would be an estimate.

The Examiner's Challenge

An examiner has the mission to properly determine the taxpayer's tax liability (including claims for applicable tax credits). In the case of the research credit, this task presents a number of potential problems. The research credit requires not only verification of the amount of the expenditures for research activities, but also a determination as to whether those activities were in the nature of qualified research. Under the best of circumstances, this is a daunting task of factual development. Returns (or claims) that are prepared using either the project or cost center approaches follow the taxpayer's existing record-keeping systems and so are manageable even when large volumes of data are involved. When the hybrid approach is employed in computing the Research Credit, the task can become insurmountable as there is no direct way for the examiner to verify that a particular expenditure is associated with a particular research activity (as there is in the project approach) and the pool of costs and activities may span the entire company (as opposed to the limited pool of costs and activities in the cost center approach). Examiners faced with this method should explain the problem to the taxpayer and solicit their assistance in resolving the lack of a nexus. There are numerous approaches to dealing with the lack of a nexus that usually involve more fully exploiting the taxpayer's managerial accounting system and the institutional knowledge of the taxpayer's employees. The Research Credit Technical Advisor team may be able to assist in formulating an approach to the nexus issue.

Conclusion & Recommendation

The approach used by the taxpayer in capturing the costs of claimed research can be a help or a hindrance in the conduct of the audit, but it should not become the subject of the audit. Examiners should avoid the "trap" of unnecessarily restricting their audit to the taxpayer's cost capturing approach, as opposed to examining the research credit that was claimed. Audit adjustments based solely upon critiques of the taxpayer's cost capturing approach usually stand little chance of being sustained in Appeals or in court.

In determining the proper liability of a taxpayer who has claimed the research credit (either filed on the original return or subsequently claimed), the examiner must conduct an audit of the taxpayer's claim. Thus, the examiner should independently plan an audit strategy that is appropriate to the taxpayer given the unique business circumstances of that taxpayer. Section 2 of the Research Credit Technical Advisor team's Audit Techniques Guide discusses the planning of an audit strategy in detail. To the extent that the records necessary to substantiate the claimed credit are already among the documents and other information gathered through the taxpayer's cost capturing approach, the taxpayer will be able to reference that information quickly and at the appropriate time, thus conserving audit resources.