
IRS introduces research credit Directive for taxpayers that report R&D costs on audited financial statements

September 21, 2017

In brief

Many taxpayers report GAAP ASC 730 research and development (R&D) costs on their certified audited financial statements. The IRS Large Business and International Division (LB&I) on September 11, 2017 signed guidance that will allow these taxpayers to take advantage of a 'safe harbor' under which an adjusted amount of their ASC 730 R&D costs can be determined as sufficient evidence of qualified research expenses (QRE) for the Section 41 credit for increasing research activities (research credit). If a taxpayer complies with the requirements of the Directive, the LB&I examiners are not to challenge certain QRE amounts for the credit year as set forth in the guidance.

This PwC Insight will explain:

- Qualification requirements;
 - Applicable eligible qualified expenses;
 - How to apply; and
 - Effective date.
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In detail

Qualification requirements

To qualify for the safe harbor, an LB&I taxpayer (i.e., assets equal to or greater than \$10 million) must report as a line item or as a footnote disclosure in its certified audited financial statements, the amount of R&D expense pursuant to ASC 730.

Applicable eligible qualified expenses

Employees

Certain employees whose costs are mapped to R&D cost centers or departments and are expensed as ASC 730 R&D may be eligible for safe harbor treatment as follows:

Qualified Individual Contributors and 1st Level Supervisor Managers

- 95% of taxable wages of Qualified Individual Contributors performing services in the United States. Qualified Individual Contributors essentially are R&D employees with no direct reports.

- 95% of the taxable wages of 1st Level Supervisor Managers performing services in the United States. 1st Level Supervisor Managers are those with only one level of employees (Qualified Individual Contributors) below them and whose wages are charged to ASC 730 cost centers.

Upper Level Managers

- Up to 10% of the amount computed above for Qualified Individual Contributors plus 1st Level Supervisor Managers is eligible as a safe harbor for Upper Level Managers. Upper Level Managers are those who directly supervise any employees other than Qualified Individual Contributors and whose wages are charged to ASC 730 cost centers.

A taxpayer may elect the 95% safe harbor for Qualified Individual Contributors and 1st Level Supervisor Managers, but choose not to use the 10% safe harbor for Upper Level Managers. If a taxpayer believes this is not effective in accurately determining the amount of actual eligible QREs from Upper Level positions, the taxpayer can forgo the 10% safe harbor and determine QREs by other means and procedures, but none of the Upper Level QREs would be eligible for the 10% safe harbor.

Supplies

R&D supply accounts and amounts expensed pursuant to ASC 730 for supplies that are consumed in the United States as part of the research process also are eligible for safe harbor inclusion as QREs.

Computer rentals and leases

Amounts paid by the taxpayer to another party for the right to use computers during the conduct of

qualified research also are eligible for safe harbor inclusion as QREs.

Contract research expenses

Contract research expenses are not eligible for safe harbor inclusion.

Exceptions

The Directive identifies exceptions to R&D supply expenses and W-2 wages that are not eligible for safe harbor treatment, even if expensed as ASC 730 R&D or incurred by Individual Contributors or 1st Level Supervisor Managers. W-2 wages and supply expenses that are not eligible for safe harbor treatment include:

- wages incurred to perform R&D under third-party contracts/agreements;
- wages used in computing the taxpayer's work opportunity credit;
- patent costs;
- severance pay;
- wages paid to employees who leave the United States and perform R&D outside the United States; and
- all prototype overhead expenses.

Taxpayers must identify these excluded amounts when preparing the safe harbor certification documentation to ensure their QRE calculations and documentation are accurate.

Observation: Taxpayers choosing to follow the Directive may still claim additional QRE from expenses outside those eligible for safe harbor treatment, but those expenses will be subject to risk assessment and possible examination.

Identifying eligible expenses

Identification of Qualified Individual Contributors, 1st Level Supervisor Managers, and Upper Level Managers

will be determined by reporting levels and department organizational structure, not by job title.

For example, an engineering employee with the job title Sr. Manager of Engineering that works on Project X and has no direct reports could be a Qualified Individual Contributor and be eligible for 95% safe harbor inclusion. However, if this same Sr. Manager of Engineering also works on Project Y and for this project supervises a 1st Level Supervisor Manager who supervises a Qualified Individual Contributor, then for purposes of this Directive the Sr. Manager of Engineering would be considered an Upper Level Manager.

Taxpayers will be required to reconcile financial statement ASC 730 R&D costs to tax QREs reported on Form 6765. (See discussion below.)

Observation: Relying solely on job titles or existing HR processes used for other purposes may not accurately reflect whether an employee is an Individual Contributor or 1st Level Supervisor Manager. Therefore, validation and further analysis are recommended.

How to apply

According to the Directive, taxpayers should attach the completed and signed Certification Statement Claiming Adjusted ASC 730 Financial Statement R&D as QREs (the Certification Statement, provided as Appendix A of the Directive) as well as Appendices B, C, and D of the Directive to their federal income tax returns to demonstrate their eligibility under the provisions of the Directive.

Appendix B is the reconciliation of Form 6765 QREs to Adjusted ASC 730 Financial Statement R&D. Appendix C is the computation of Adjusted ASC 730 Financial Statement R&D. Appendix D is the wage detail for the

taxpayer's Adjusted ASC 730 Financial Statement R&D.

If these documents are not voluntarily attached to a taxpayer's return, the IRS audit team at the beginning of its examination of the taxpayer's research credit will verify whether the taxpayer has followed or plans to follow the Directive. For taxpayers choosing to follow the Directive, the audit team will then ask the taxpayer to provide the certification documents (Appendices A through D of the Directive).

Taxpayers also will be required to retain and make available to the audit team upon request the underlying documentation that supports the amounts claimed on Appendices C and D. The Directive includes a non-exhaustive list of such documentation.

Effective date

The Directive applies only to original returns timely filed (including extensions) on or after the date of the Directive, for LB&I taxpayers that

choose to follow the terms of the Directive.

The takeaway

All taxpayers currently claiming research credits should perform a feasibility analysis to determine if the safe harbor would be beneficial as compared to their current approach for identifying QREs.

Taxpayers seeking to use the safe harbor will have to establish the needed organizational reporting levels and structure of employees whose costs are expensed as ASC 730 Financial Statement R&D as well as identify the appropriate financial information to complete the required Appendices. This could be done by:

- Extracting, organizing, and validating data that is already captured in internal human resource systems or databases, or third-party ERP and talent management software or applications.

- Creating an organizational and reporting-level internal structure if one does not exist, and validating that structure through the use of automated tools and subject-matter experts.
- Reconciling Financial Statement ASC 730 R&D to Adjusted Financial Statement ASC 730 R&D, and Form 6765 QREs totals (i.e., what is required on Appendices B through D of the Directive).

Companies that currently do not disclose ASC 730 Financial Statement R&D in their financial statements but that want to participate in the safe harbor going forward will have to identify, compute, and report those amounts so they can be presented in future audited financial statements.

Finally, companies should assess and then compute their amounts of QREs likely to be generated from areas outside the safe harbor categories and create the appropriate documentation to substantiate this subset of QREs.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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