

33rd Annual High Technology Tax Institute
Sponsored by Tax Executives Institute, Inc. & San Jose State
University College of Business
November 13 & 14, 2015

LB&I Directive-R&D Credit

Guidance on Allowance of Credit for Increasing
Research Activities under IRC 41 for Taxpayers
that Expense R&D Costs on their Financial
Statements pursuant to ASC 730



Panel Members

Kimberly Edwards – IRS Director, Western Compliance Practice Area
Nora Beltran – IRS Team Manager, SF Bay Area
Janine Jones – IRS Subject Matter Expert, GBC Practice Network
Paul Zamolo – IRS LB&I Deputy Area Counsel
Barry Slivinsky – Silicon Valley Tax Directors Group Co-Chair
Jeffery Jones – PWC R&D Services Leader

GOAL

Strategically reduce the deployment of resources related to the examination of research credit issues.

Background

- IRS audits in this area of the country (Silicon Valley) typically focus on R&D Credit.
- Companies spend considerable time documenting and calculating the R&D credit.
- There is no consistent method followed by companies in calculating the R&D credit.
- There is no uniformity amongst companies in how the support is presented.

Background (cont'd)

- The total resources expended between filing and auditing the credit were burdensome.
- The Silicon Valley Tax Directors Group & PWC approached the IRS to collectively find a solution.

Background (cont'd)

- Joint effort between IRS and external stakeholders.
- Several meetings both face-to-face and via phone conference.
- Capital IQ data research to determine affected population.
- Empirical data testing using live taxpayer information from volunteer companies.

LB&I Directive – R&D Credit

- Applies to LB&I taxpayers only.
- Applies to original returns (including extensions) filed on or after 9/11/2017.
- Provides guidance to LB&I examiners regarding examination of qualified research expenditures (QREs).

LB&I R&D Credit Directive

LB&I Directive – R&D Credit (cont'd)

- If not attached to tax returns, completed disclosure statements will be provided to the exam team at the beginning of the exam process.
- Taxpayer must retain and make available upon request the underlying books and records as listed on Part IV of the Directive.
- Examiners may request the underlying books and records to verify compliance with the certification requirements.

Eligible Participants

- LB&I Taxpayers with:
 - Certified Audited Financial Statements; **and**
 - Followed ASC 730 GAAP Accounting; **and**
 - Separately stated “Research & Development” line item on income statement; **or**
 - “Research & Development” expenses quantified on the notes to the financial statement.

Certified Audited Financial Statements

- Reliance on audit procedures and due diligence performed by the financial auditors.
- Reliance on audited financial statements
 - Audit procedures performed by financial auditors.
 - Governed by GAAS (generally accepted auditing standard).
 - Code of Professional Conduct
 - Public companies
 - ✓ PCAOB—Public Company Accounting Oversight Board
 - ✓ SEC—Securities and Exchange Commission
 - ✓ SOX—Sarbanes Oxley Act of 2002

ASC 730

- Rely on ASC 730 for companies with separately stated line item or footnoted on Certified Audited Financial Statement.
- Reliance on Accounting Standard Codification 730 (ASC 730).
 - Similarities between types of activities under ASC 730 and IRC 41 & 174.
 - Similarities between types of cost under ASC 730 and IRC 41 & 174.
 - Interactions with other accounting pronouncements e.g. ASC 985 and 350.

Requirements

- Follow template included in the Directive to compute “safe harbor” QREs.
- Documentation requirement
 - Objective starting point in QRE review,
 - Validate accounts added/subtracted on the template using financial statement details, and
 - Adherence to the documentation requirements.

Process

Appendix B – Reconciliation of Form 6765 QREs to Adjusted ASC 730 Financial Statement R&D

Appendix B – Reconciliation of Form 6765 QREs to Adjusted ASC 730 Financial Statement R&D					
Form 6765 Line Number	Description	A Adjusted ASC 730 Financial Statement R&D QRE Amounts: From Appendix C	B Additional QRE Amounts From ASC 730 accounts not included in Adjusted ASC 730 Financial Statement R&D	C Additional QRE Amounts Not From ASC 730 accounts	D Total QRE Amounts claimed on Form 6765
		A	B	C	A + B + C = D
5 or 24	Wages for qualified services (do not include wages used in figuring the work opportunity credit)	xx,xxx,xxx	xx,xxx,xxx	xx,xxx,xxx	xxx,xxx,xxx
6 or 25	Cost of supplies	xx,xxx,xxx	xx,xxx,xxx	x,xxx,xxx	xxx,xxx,xxx
7 or 26	Rental or lease costs of computers (see Form 6765 instructions)	xx,xxx,xxx	xx,xxx,xxx	xx,xxx,xxx	xxx,xxx,xxx
8 or 27	Enter the applicable percentage of contract research expenses (see Form 6765 instructions)	N/A	xx,xxx,xxx	xx,xxx,xxx	xx,xxx,xxx
	Total	xxx,xxx,xxx	xxx,xxx,xxx	xxx,xxx,xxx	xxx,xxx,xxx
		Column A total must equal Line 19 in Appendix C			

Page 6 of 13

13



Process (cont'd)

Appendix C – Computation of Adjusted ASC 730 Financial Statement R&D

Line #	Description	Year
1	ASC 730 Financial Statement R&D	Step 1 XXX,XXX,XXX [A]
2	Subtract: All Amounts Related to Foreign Entities	Step 2 (XX,XXX,XXX)
3	U.S. ASC 730 Financial Statement R&D	XXX,XXX,XXX [B]
3a	The Schedule M-3 amount (see instructions)	XXX,XXX,XXX
4	Subtractions from U.S. ASC 730 Financial Statement R&D	Step 3
5	All U.S. ASC 730 Financial Statement R&D GL Accounts or items specifically Excluded from Sec. 174 such as (i) Quality Control Testing; (ii) efficiency surveys; (iii) management studies; (iv) consumer surveys; (v) advertising; (vi) the acquisition of another's Patent, model, production or process; and (vii) research in connection with literary, historical or similar projects.	XX,XXX
6	All U.S. ASC 730 Financial Statement R&D GL Accounts that are non-Wage, non-Supply and non-Contract Research such as depreciation, amortization, shipping, travel, training, rent, overhead, general and administrative expenses and all other items not eligible for section 41 QREs.	XX,XXX
7	All U.S. ASC 730 Financial Statement R&D costs incurred for all agreements/contracts pursuant to which Taxpayer performed ASC 730 research in order to comply with the terms of the agreements/contracts. These costs are to be subtracted regardless of whether incurred in connection with Funded Research.	XX,XXX
8	All U.S. ASC 730 Financial Statement R&D costs incurred for all persons other than Taxpayer's employees who performed ASC 730 research on behalf of Taxpayer.	XX,XXX
9	All U.S. ASC 730 Financial Statement R&D In-house Research performed outside the U.S.	XX,XXX
10	All Prototype Overhead expenses, patent costs and severance pay included in U.S. ASC 730 Financial Statement R&D.	XX,XXX
11	TOTAL SUBTRACTIONS STEP 3	(XXX,XXX) [C]
11a	Subtotal U.S. ASC 730 Financial Statement R&D After Subtractions	B - C = D XXX,XXX,XXX [D]
12	U.S. ASC 730 Financial Statement R&D Employee Wage Adjustment	Step 4
	W-2 Wages for employee compensation added to U.S. ASC 730 Financial Statement R&D in this Step should NOT include any amounts relating to the above subtractions. Further, the W-2 wages should only relate to Wage costs that are charged to U.S. ASC 730 Financial Statement Cost Centers.	
13	Subtract U.S. ASC 730 Financial Statement R&D Wage and Wage Related Accounts not already subtracted in the lines above.	(XX,XXX)
14	Subtract U.S. ASC 730 Financial Statement R&D Stock-Based Compensation not already subtracted in the lines above.	(XX,XXX)
	Amounts on lines 15, 16 & 17 are calculated using Appendix D - Adjusted ASC 730 Financial Statement R&D Wage Detail.	
15	Add 95% of W-2 Wages for Qualified Individual Contributors.	XX,XXX
16	Add 95% of W-2 Wages for 1st Level Supervisor Managers.	XX,XXX
17	Add Upper Level Managers' Limit	XX,XXX
18	TOTAL STEP 4	XX,XXX [E]
19	ADJUSTED ASC 730 Financial Statement R&D	D + E = F XXX,XXX,XXX [F]
	ADJUSTED ASC 730 Financial Statement R&D; QRE AMOUNTS	Step 5 cont.
	(Transfer these numbers to Appendix B Form 6765 "Adjusted ASC 730 Financial Stmt. R&D" Column)	
20	Wages for qualified services (Form 6765 Line 5 or 24)	XXX,XXX,XXX
21	Cost of supplies (Form 6765 Line 6 or 25)	XX,XXX,XXX
22	Rental or lease costs of computers (Form 6765 Line 7 or 26)	XX,XXX,XXX
	ADJUSTED ASC 730 Financial Statement R&D QRE AMOUNTS (Form 6765 Line 9 or 28)	XXX,XXX,XXX
	This Amount should equal [F] above	

Page 7 of 13

14



Process (cont'd)

Appendix D - Adjusted ASC 730 Financial Statement R&D Wage Detail

The Upper Level Managers' Limit for employees whose Wage costs are charged to U.S. ASC 730 Financial Statement Cost Centers:

1. 95% of Qualified Individual Contributors Base W-2 Wages	XXXXXXXXXX	
2. 95% of Qualified Individual Contributors - W-2 Stock Options	XXXXXXXXXX	
3. Total W-2 Wages for Qualified Individual Contributors		\$ -
4. 95% of 1st Level Supervisor Managers Base W-2 Wages	XXXXXXXXXX	
5. 95% of 1st Level Supervisor Managers - W-2 Stock Options	XXXXXXXXXX	
6. Total W-2 Wages for 1st Level Supervisor Managers		\$ -
7. The Upper Level Managers' Limit - The lesser of: (a) 10% of the sum of lines 3 and 6, above; or (b) 100% of the W-2 Wage and W-2 Stock Option costs for Upper Level Managers, which are charged to U.S. ASC 730 Financial Statement Cost Centers. If Taxpayer wants to include more than the Upper Level Managers' Limit in QREs, 100% of the W-2 Wage and W-2 Stock Option costs for Upper Level Managers is considered to be S-0.		\$

Instructions

- 95% of the base W-2 Wages for Qualified Individual Contributors which wage costs are charged to U.S. ASC 730 Financial Statement Cost Centers.
- 95% of the W-2 Stock Option Wages for Qualified Individual Contributors which wage costs are charged to U.S. ASC 730 Financial Statement Cost Centers.
- Total of lines 2 and 3.
- 95% of the base W-2 Wages for 1st Level Supervisor Managers which wage costs are charged to U.S. ASC 730 Financial Statement Cost Centers.
- 95% of the W-2 Stock Option Wages for 1st Level Supervisor Managers which wage costs are charged to U.S. ASC 730 Financial Statement Cost Centers.
- Total of lines 4 and 5.
- The Upper Level Managers' Limit is the lesser of: (a) 10% of the sum of lines 3 and 6, above; or (b) 100% of the W-2 Wage and W-2 Stock Option costs for Upper Level Managers, which are charged to U.S. ASC 730 Financial Statement Cost Centers. If Taxpayer wants to include more than the Upper Level Managers' Limit in QREs, 100% of the W-2 Wage and W-2 Stock Option costs for Upper Level Managers is considered to be S-0- and any amount claimed for Upper Level Managers will be subject to risk analysis and examination.

BENEFITS

- Uniform verified starting point for determining QREs.
- Mechanical computation of QREs.
- Reduce exam and taxpayer resources devoted to examining issue.
- Audit of books & records vs. review of qualified activities.
- Provide consistent process for taxpayer to identify expenses outside of ASC 730.

BENEFITS (cont'd)

- Reduce costs and burden of conducting surveys.
- Reduce audit risk.
- If only safe-harbor QREs claimed:
 - No Schedule UTP and
 - No Fin 48 Disclosure.
- Risk assessment tool.

Questions

Questions?