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KBKG TAX INSIGHT: WORDS MATTER WHEN DESCRIBING R&D CREDIT ACTIVITIES

As featured in Accounting Today

Most audits of the R&D credit are conducted by revenue agents that are accountants.

We've all experienced a situation where our intent and the meaning of something we've said or written was misinterpreted by the recipient. There are numerous articles available for many situations to help us avoid this problem, such as the how to ask the boss for a raise or the best way to close a deal. These same concepts are just as important when the IRS is auditing the R&D credit. In this article, I'll try to help you avoid some of the problems that can come up during an audit by using the wrong words.

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- Cost Segregation
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Word Choice Matters

From my experience, there are words often used to describe qualified research that unfortunately are used in IRS training to describe non-qualified research.

KBKG Insight:

Most audits of the R&D credit are conducted by revenue agents that are accountants. They typically do not have the expertise to challenge the engineers and scientists that performed the research on the technical aspects. They will often instead focus on the accounting aspects of the credit calculations and on identifying any non-qualifying or excluded activities that were included as research.

Here are a few examples of how terms used by the IRS to describe non-qualified research can cause heartburn when used to describe qualified research.

Troubleshooting

When a production malfunction occurs, the technicians, engineers, and scientists involved may decide to make changes to prevent a reoccurrence instead of only fixing whatever has gone wrong. Process improvements that began as troubleshooting are unfortunately still often described that way in research documentation. Then the auditor proposes to disallow the project, because the IRS defines troubleshooting as restoring the process to its earlier state. If your research activity is actually **process improvement** make sure that it's not referred to as troubleshooting in the credit documentation.

Routine Quality Assurance

Routine quality assurance (QA) refers to ensuring that normal production meets process and product standards. However, QA is also commonly used by engineers and scientists when describing efforts to check that new product prototypes and processes meet the operating parameters of the design. The problem with using the term QA is exacerbated when QA personnel have the equipment and expertise necessary to confirm that the new design is functioning as intended. We recommend that when describing research activities, instead

of using QA, describe the activity as **design verification, performance parameter testing** or some other term that accurately describes the activity. It might eliminate some confusion and explanations needed to convince a revenue agent that this isn't non-qualified QA.

Market Research & Brainstorming

The genesis of a new product often begins when customers, salespeople, and marketing identify a need or when competitors have introduced products with superior features. Marketing and technical sales personnel are often included in the initial discussions on the features, performance parameters, and design of a new product. Their efforts to assist the engineers and scientists are frequently included as qualified R&D credit activities. The problem that occurs during audit is that these initial design activities, described as market research, idea generation, or brainstorming, are terms that the IRS use to describe non-qualified research activity. The logic supporting the IRS' position is that experimentation has not begun during these initial efforts to identify new product features. I'd contend that the process of experimentation begins when you identify technical uncertainties related to the design parameters and features that you will ultimately try to incorporate into a successful product. These first design efforts are more likely to be accepted as qualified research if they are identified as **preliminary parameter identification, initial design, or product performance determinations**. Including sales and marketing personnel as performing qualified research is likely to always be viewed skeptically by an IRS auditor. The more that you can demonstrate that they contributed to the process and had the technical expertise needed to participate in the design, the more likely it is that the IRS will agree that their reported efforts were qualified R&D activities.

These are just a few things to consider when documenting activities for the R&D Tax Credit. Should you have questions or need guidance, our R&D tax credit team of former IRS experts and experienced technical leaders are here to help. Contact us today.

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