

## IRS Safe-Harbor to Calculate Federal Income Tax Credits for Research Expenses

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A taxpayer may claim a credit against its federal income tax liability for research expenses paid or incurred during the tax year.

The definitions of research expenses for financial reporting purposes and federal income tax purposes are different. Because of the difference, a taxpayer was not able, in an IRS audit, to substantiate its tax credits for research expenses by showing the IRS the research expenses in its financial statement. To obtain the necessary proof, many taxpayers conducted separate research credit studies, which they presented to the IRS if audited. The study might have been costly to prepare, and there was no assurance that the IRS would accept its findings.

The IRS Large and Mid-Size Division ("LB&I") recently published a safe-harbor that avoids the need for a separate study. If a taxpayer comes within LB&I's safe harbor, LB&I will accept a percentage of the wages of certain employees and also the cost of certain supplies as creditable research expenses. The safe-harbor relies on amounts, as adjusted, in the taxpayer's certified audited financial statement that properly accounts for research and development costs pursuant to Accounting Standards Codification 730 ("ASC 730"). For financial statement purposes, ASC 730 determines whether a particular activity is research and development, and if it is, what costs may be charged to income currently as research and development costs.

The advantage of the ASC 730 safe-harbor is that a taxpayer does not have to prove to the IRS that wages that the taxpayer claims as qualified research expenses were paid to employees who worked on projects that came within the tax definition of qualified research. The IRS will assume that employees whose wages were within ASC 730 and accounted for as research costs in the financial statement qualify for the tax credit. The IRS also will assume that the taxpayer used supplies in projects that came within the tax definition of qualified research if the taxpayer properly accounted for the cost of the supplies pursuant to ASC 730.

The ASC 730 safe-harbor directive applies only to research credits that a taxpayer claims in its original return for the tax year. It will not apply to additional research credits reported in an amended return. Also, the safe-harbor does not apply to all costs that qualify for the research credit. The safe-harbor applies only to certain categories of wages and to the cost of supplies. A separate study may still be needed to substantiate other categories of research, like contract research, for the tax credit.

A taxpayer availing itself of the ASC 730 safe-harbor may well lose some credits that could be substantiated by a separate study. The wages of employees who perform research and who do not manage any other employee ("Qualified Individual Contributors") are counted for the credit at 95% rather than 100%. The wages of a manager who directly manages only Qualified Individual Contributors ("First Level Supervisor Managers") also are counted for the credit at 95% rather than 100%. The wages of a manager who directly supervises any employee other than a Qualified Individual Contributor ("Upper Level Managers") is counted for the credit at the lesser of (i) 10% of the sum of the wages of Qualified Individual Contributors and First Level Supervisor Managers or (ii) 100% of the wages of the Upper-Level Managers charged to research expense pursuant to ASC 730. If the taxpayer claims more wage expense for an Upper-Level Manager than this formula permits, the wages in "(ii)" are reset to zero. The wages of the Upper-Level

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Managers would not then be within the ASC 730 safe-harbor, and LB&I may separately determine the amount of the wages of Upper-Level Managers that are counted for research credit purposes.

Taxpayers using the ASC 730 safe-harbor should expect LB&I to use the taxpayer's organization charts to identify Qualified Individual Contributors, First Level Supervisor Managers, and Upper-Level Managers.

Finally, the ASC 730 safe-harbor requires the taxpayer to provide to LB&I upon request its audited financial statement, chart of accounts, a list of cost centers the expenses of which are charged to research pursuant to ASC 730, and generally all the categories of documentation that the IRS typically requests when it conducts a research credit audit.

Depending on particular circumstances, a taxpayer may find that the ASC 730 safe-harbor produces less credit that would be produced by an independent study. Moreover, certain categories of research expenses, like contract research, which may well qualify for the research credit, are not the subject of the ASC 730 safe-harbor and would still have to be separately calculated and substantiated.

Taxpayers preparing their 2017 federal income tax credit for research expenses should consider whether to use LB&I's ASC 730 safe-harbor or to conduct a separate study. Each taxpayer thus should determine if the certainty derived from using the ASC 730 safe-harbor for specified categories of wages and supplies justifies the possible loss of credits that the taxpayer would have calculated in an independent study. Loren Opper, Ryan Riehl, and Gary Glenn at Miller Canfield are available to assist in answering this question.