

Tax Notes

R&D Tax Credit: Court Emphasizes Need to Document Project Qualifications

By Sandy Weinberg, JD, Principal and Jill Cantor, JD, CPA, Senior Tax Manager

Claiming the federal research tax credit is easier and more beneficial than ever. Federal law and IRS regulatory changes have made that so. Nevertheless, the recent U.S. Tax Court decision, *Siemer Milling Company v. Commissioner of Internal Revenue*, emphasizes that without proper documentation, all of those tax benefits – as if in an Avenger movie – can vanish with the snap of two fingers.

Detailed Documentation a Must

In *Siemer Milling*, the taxpayer, a wheat flour miller and seller, claimed a research credit for several projects. The credit amount taken approximated \$120,000 per year. The IRS audited two years, and disallowed the credit in both, claiming that the taxpayer failed to prove that the projects qualified for the credit. The taxpayer appealed.

In reviewing the IRS determination and information provided by the taxpayer, the Tax Court found that the credit documentation failed to establish that any of the projects at issue met all four tests required for a project to constitute qualified research, namely, that the projects

- 1) eliminated uncertainty;
- 2) were technological in nature;
- 3) involved the process of experimentation; and
- 4) met the business component tests.

The Tax Court thus sustained the credit disallowance by the IRS.

Primarily, the Tax Court held that the taxpayer failed to prove that the projects met the process of experimentation test, which required that the company conduct “trials to test a hypothesis, analyze the data, refine the hypothesis and retest the hypothesis so that it constitutes experimentation in the scientific sense.”

Further, for some projects, the taxpayer did not establish that its project’s activities were intended to discover information to eliminate uncertainty concerning the development or improvement of a product.

In one instance, the Tax Court stated that the taxpayer failed to meet the business component test because it didn’t adequately explain how its improvements to a machine it was developing helped improve the milling process or the product they sold.

Finally, the *Siemer Milling* court stated that the taxpayer in some projects failed to explain how the technological information test was met, in that the taxpayer did not establish the engineering, computer science, or physical or biological sciences principles on which the purported research activities relied.

What both the IRS audit and the Tax Court make clear is that the documentation bar is high when it comes to supporting a research credit claim. For each research project/activity, a narrative along with supporting contemporaneous documentation (including, for instance, board minutes, emails and marketing materials, etc.) explaining the project and how it meets the research credit criteria is needed.

The documentation requirement doesn't end there. It is also imperative that the amounts of research wages, contract research, and supplies claimed be supported as well.

Easing the Burden and Increasing the Benefit of Claiming the Federal Research Tax Credit

Nevertheless, even with a relatively difficult documentation burden, the federal research credit easily could be worth pursuing. Recent positive developments have included:

- The alternative simplified credit (ASC) method can now be used in claiming the credit on amended returns;
- Qualified start-ups may claim up to a \$250,000 credit against their FICA payroll taxes in lieu of utilizing the credit against income tax (which they may not have);
- Regulations have narrowed the definition of the more difficult to claim internal-use software; and
- The potential credit amount available has increased due to the overall tax rate reduction under the Tax Cuts and Jobs Act combined with the mechanics of the research credit.

Endgame

In light of these beneficial developments, taxpayers should analyze their research credit opportunity. If moving ahead is appropriate, the somewhat arduous task of documentation should then be undertaken. With proper documentation, the world may not be saved from evil villains, but your research credit should survive.

Contact Us

If you have questions regarding the federal research credit or supporting a claim, contact:

Sandy Weinberg, JD
Principal
sweinberg@pkfod.com | 203.705.4170

Jill Cantor, JD, CPA
Senior Manager
jcantor@pkfod.com | 203.705.4174

www.pkfod.com

About PKF O'Connor Davies

PKF O'Connor Davies, LLP is a full-service certified public accounting and advisory firm with a long history of serving clients both domestically and internationally. With roots tracing to 1891, eleven offices in New York, New Jersey, Connecticut, Maryland and Rhode Island, and more than 700 professionals, the Firm provides a complete range of accounting, auditing, tax and management advisory services. PKF O'Connor Davies is ranked 29th on *Accounting Today's* 2019 "Top 100 Firms" list and is recognized as one of the "Top 10 Fastest-Growing Firms." PKF O'Connor Davies is also recognized as a "Leader in Audit and Accounting" and is ranked among the "Top Firms in the Mid-Atlantic," by *Accounting Today*.

PKF O'Connor Davies is the lead North American representative in PKF International, a global network of legally independent accounting and advisory firms located in over 400 locations, in 150 countries around the world.

Our Firm provides the information in this e-newsletter for general guidance only, and it does not constitute the provision of legal advice, tax advice, accounting services, or professional consulting of any kind.