

IRS Audit Plan for the Research Tax Credit

In 1995, the IRS released two audit plans for use by examiners auditing the research credit. One plan focuses on the research credit in general and the other is specific to internal use software. Highlights of the plans are summarized below. The plans give a good overview to the detail and focus of the IRS in auditing the credit.

Research Tax Credit Audit Plan

Information to request:

- § All workpapers used to compute the credit. Will indicate whether credit computed using a “cost center/departmental approach, project approach or just listing the specific expenses that qualify.”
- § Use a two-prong approach: 1) determine whether the expenses qualify for the credit and 2) determine if the activity is qualified research per §41(d).
- § If the research is highly technical, consider getting an IRS engineer involved.
- § Meet with the taxpayer to get an explanation of the workpapers and overall research activity. Find out if the records are contemporaneous, what criteria were used to determine what qualified for the credit, were employee surveys used? Ask for the surveys and instructions.
- § Take a tour of the research facilities.

Review of Expenses:

- § Request a written description of each cost center and each account.
- § Examine the wage component. “At a minimum, employees with questionable job titles and duties such as administrative, manufacturing, managerial, etc. should be reviewed.” Request personnel files for review.
- § Review accounts used to measure supplies expense to be sure they are really supplies (which should be a small percentage of the credit (per the IRS)).
- § Review the contract research costs to determine if qualified research was performed, who was at risk and who obtained substantial rights to the research.

Review of Projects or Activities

- § Determine if the activity or project meets the definition of “qualified research” at §41(d). Request explanations/descriptions/documentation from the taxpayer.

Other Information to Consider:

- § Organizational charts
- § Accounting, financial, policy and other manuals describing R&D activity.
- § Brochures or press releases explaining research activities.
- § Items given to management or the Board of Directors explaining R&D projects.
- § Documents prepared by or on behalf of internal auditors.
- § Patent and copyright applications
- § Minutes or notes from budget, board, managerial and similar meetings involving R&D activities.

§ Progress reports of projects and meeting minutes.

Potential Issues That Should Be Considered When Examining the Credit

- “a. Technical writers and other individuals who prepared the end user manuals or other instructive documents to the end user. This is a coordinated issue.
- b. Payments to a deferred compensation plan or trust such as an I.R.C. sec. 401(k) plan and matching employers contributions.
- c. Employee fringe benefits and other compensation not considered wages under IRC sec. 3401(a).
- d. Managers above first line supervisors.
- e. Purchased, licensed or leased software.
- f. Utilities.
- g. Overhead expenditures.
- h. Travel.
- i. Research tax credit claimed on costs associated with fixed-price government contracts.
- j. Research tax credit claimed on costs associated with the development of a generic drug.”

Audit Plan for Development Costs of Internal-Use Software

The basics guidelines are similar to those in the general audit plan (above). Selected additional points made in this plan include the following:

- § Job titles “that appear to be outside the scope of a software developer should be challenged.”
- § Request job descriptions and employee evaluations.
- § Request the contracts for outside consultants performing qualified research.
- § Examples of non-qualifying software development activities: software core, installation costs, training costs, pre-software development costs, and non-software development costs. Should particularly look for these included in an outside contract.
- § “Challenge the software development activity.”
- § Get written explanations from the taxpayer as to purpose of projects and why they meet §41(d).
- § “Contemporaneous records should be produced by the taxpayer to support the claim. If surveys are used, the official completing the survey should be interviewed.”