



Clarifying the R&D Tax Credit

Many questions have been raised concerning what industries and specific activities may qualify for R&D Tax Credits. We would like to discuss some of the most common, recent questions in order to educate our clients and partner firms about potential opportunities to claim the credit. Many questions cannot be adequately covered with general answers, as each taxpayer's situation is unique. However, we can provide some clarity and awareness.

Do architecture firms make good R&D Tax Credit clients?

In general, most design work undertaken by architecture firms does not meet the requirements for qualified research. It is however, possible for architecture firms to qualify for tax credits by dedicating resources toward specialized research and design work for unique projects. Different geographic regions have different required design elements for efficiency, such as LEED certification. Design efforts to achieve efficiency and technological characteristics might qualify depending on the specific circumstances, but aesthetic elements do not.

There may be a level of technical uncertainty when determining which elements and components will be most efficient. Some examples of determining efficiency and quality include

experimenting with material durability, longevity, or how design features of a structure affect heat dissipation. In order to qualify, activities must meet the process of experimentation requirement through physical prototype testing or the use of 3D modeling software, such as CAD, to perform virtual efficiency testing.

Like many companies that take the R&E credit, wages are the most common includable expense. Architecture firms' includable expenses are derived from the wages of qualified employees and contract designers/engineers. There also may be includable supply costs, such as scaled models or prototype components used in experimentation.

How can consulting engineers and mechanical contractors qualify for the credit?

After an architect designs a building, consulting engineers who specialize in assuring the integrity of the structure may be hired to assist in design and evaluation. Examples of consulting engineers include mechanical, electrical, plumbing, structural and civil engineers. Consulting engineers can qualify for R&D Tax Credits when improving upon the design for efficiency or function while collaborating with the architect. Again, a process of experimentation is required and is often



Our goal is to maximize research credits while providing defensible and conservative claims to the IRS.

– TJ Sponsel
Managing Director
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performed through virtual testing, which can include hydraulic analysis, pipe stress analysis, load calculations, and performance evaluations.

The general contractor or owner then hires a mechanical subcontractor to specify and install all mechanical, electrical, and plumbing systems. The mechanical subcontractor analyzes the drawings and interfaces with the engineering consultants to optimize the systems, select the best equipment, and provide ideas on how to improve the design. This is where the mechanical subcontractor might get involved with qualified activity. However, after receiving designs, the majority of mechanical subcontractors focus solely on performing the physical labor, which would not qualify for the R&D Credit.

It is important to consider the nature of the project when determining a mechanical subcontractor's likelihood of qualifying for the R&D Credit.

Infrastructures can include residential, multi-unit residential buildings, commercial, and industrial projects. It is less likely to qualify for the credit when subcontractors are simply constructing buildings or homes to code. Industrial projects have a greater chance of involving qualifying activities since each project is unique. Subcontractors can potentially qualify if they see areas within a system design that could be optimized and provide efficiency improvements or even engineering recommendations. Industrial projects also require a testing period during and after they are installed to determine efficiency. Some common

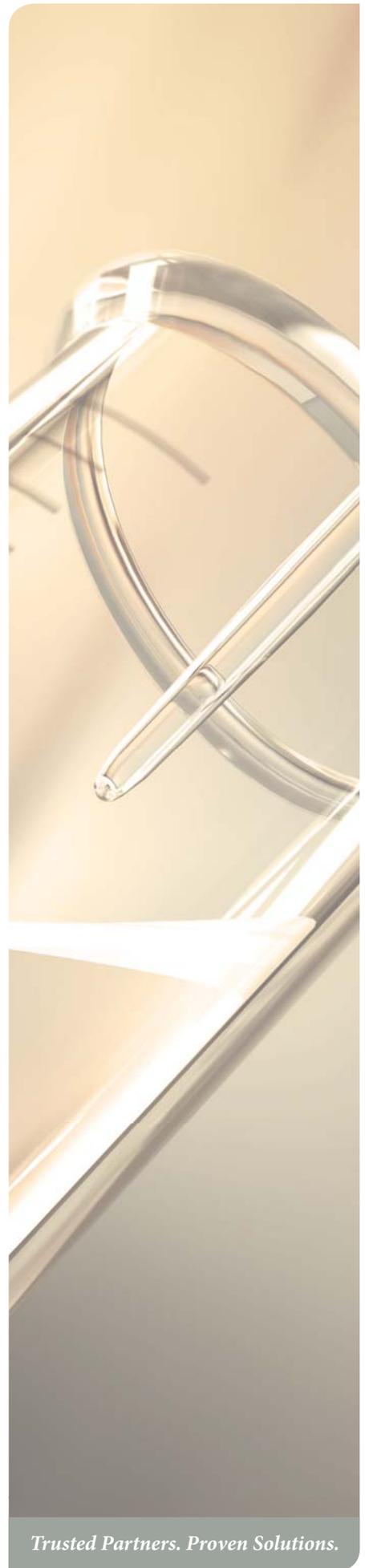
industrial projects that could include qualifying research include the design and implementation of industrial ventilation systems, process heating and cooling systems, custom chilled water systems, or instrumentation/control systems.

What is the Proper Use of Estimates when Calculating R&D Expenses?

Estimates rely on the testimony of taxpayer employees regarding qualifying activities. Therefore, educating taxpayers about the criteria for qualifying research is essential. It is imperative that taxpayers who are making assertions regarding qualifying activities have a working understanding of what activities do and do not qualify. A thorough review of both day to day activities and larger projects can also help with the process of finding qualifying activities. This review allows for the creation of estimates where the client is educated regarding how their specific activities do or do not qualify.

Companies should estimate time by each employee and how he or she contributes to the project. These estimates are placed on a time questionnaire and signed off on by the employee or immediate supervisor. Time questionnaires help determine what percentage of time is filled with qualifying activities vs. non-qualifying activities.

When using estimates, substantiation with contemporaneous documentation is critical to demonstrating qualification to the IRS. Examples of contemporaneous documentation include design data, drawings, models and testing/



experimentation reports. The court case *Cohan v. Commissioner* is an excellent example of the importance of maintaining accurate records:

This is made known in the “Audit Techniques Guide: Credit for Increasing Research Activities” published June, 2006:

“The Courts will allow the use of an estimation method only where the taxpayer does not have contemporaneous (time and expense tracking) records, and then only as long as the following two conditions are satisfied. First, the taxpayer must establish that it engaged in qualified research activities as defined in section 41(d). And second, the failure to maintain a proper system to capture relevant information cannot be an “inexactitude is of their own making.” Estimation methods are permitted only in cases where the sole issue is the exact amount paid or incurred in the qualified research activity. Accordingly, Taxpayers must have factual support for every assumption underlying their estimates to meet their burden of proof.”

Therefore, if the taxpayer has not maintained accurate records of the precise dollar amounts consumed by research and experimentation efforts, qualified research expenditures may be estimated in accordance with the *Cohan* Rule. This rule refers to the G.M. *Cohan* ruling (*Cohan v. Commissioner*) in the Second Circuit Court of Appeals in 1930, which allowed qualifying business expenses to be estimated when exact records and receipts are not available.

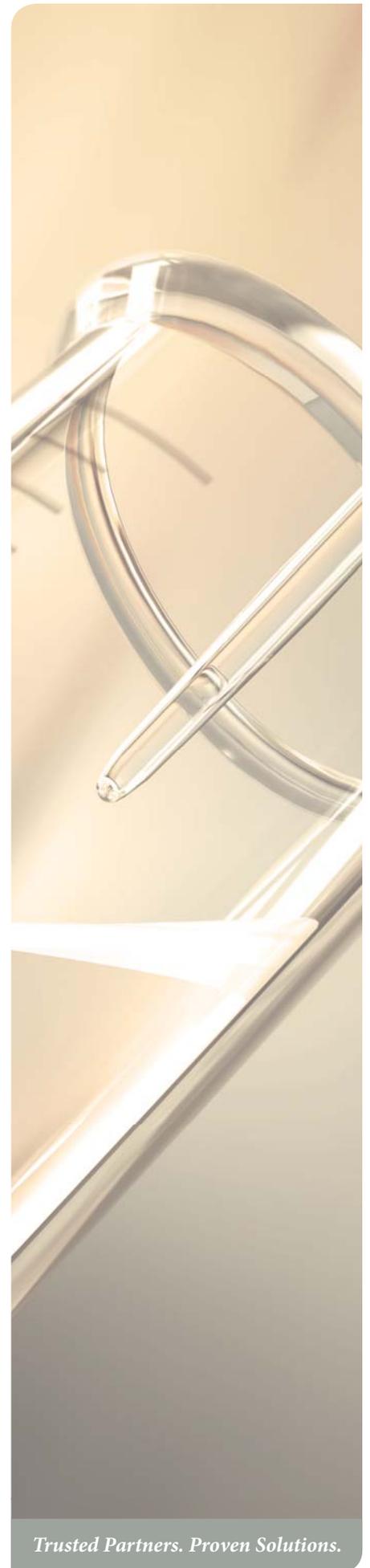
This ruling can be applied to quantify the research expenses related to the development and improvement of new and existing business components that qualify for inclusion in the R&D Tax Credit. This can be seen in the rulings of the Tax Court in *Union Carbide v. Commissioner*:

“Under the reasoning in *Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930), we accept petitioner’s list of identified runs, including concessions, as a close approximation of all of the qualified research activities that occurred during the base period.”

The *Cohan* Rule states that credible oral or written testimony can be used to make these estimations only when contemporaneous supporting documentation is present. This documentation must provide reliable substantiation as a basis for making the estimation.

Can Management’s Wages be Included?

At first glance, the IRS may cast doubt upon the amount of time an owner may have invested in qualified activities. The normal activities of executives generally do not qualify. However, owners of small companies are often driving the research and development process. If owners or managers are directly engaged in qualified activities or are managing qualifying activities then they likely have includable wages. These qualified activities enable owners to include some of their time and wages as qualified expenses. Including even a portion of an owner’s wages and activities can produce



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significant tax credit increases.

These activities must be proven with contemporaneous documentation. Two ways to substantiate qualification with contemporaneous evidence include 1) technical email correspondence internal or external or 2) quotes or proposals put together by management that require a technical understanding of the details. It is highly recommended that management track their time involvement in qualifying activity as they participate. The court case *Basim Shami and Rani Ardah, et al. v. Commissioner* is a prime example of the importance of properly qualifying and documenting management's wages.

In this instance, the taxpayer hired another outside provider to develop R&D Credit claims for tax years 2003, 2004 and 2005. The provider included nearly \$30 million in management wages over a three year period for two individuals whose titles and educational backgrounds did not indicate a strong likelihood that they would materially participate in qualifying research. Additionally, the taxpayer failed to provide any documentation that established how much, if any, time was spent by management performing R&D activities. The court found the provided testimony to be unreliable and contradictory. The IRS is very clear in their expectations for substantiating management involvement in qualifying research activities. Taxpayers and practitioners should be meticulous in maintaining and presenting contemporaneous evidence to support such inclusions.

At McGuire Sponsel we believe it is critical to answer our clients' questions and arm them with the facts to make informed decisions. Our experience in tax, engineering and architecture allows us to help clients understand what constitutes qualifying activities for the R&D Tax Credit. Our aim is to maximize research credits while providing defensible and conservative claims to the IRS. Contact McGuire Sponsel today to discuss what opportunities you have available.

