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// R&D Tax Credit

Commonly Asked Questions Concerning R&D Tax Credit Audits

> **Audit occurrence, agent's experience, and substantiation are three distinct categories that affect the R&D Tax Credit audit.**
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> – TJ Sponsel
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We would like to take a moment and address some frequently asked questions that are raised regarding opportunities for the R&D Tax Credit. Given the audit environment and the IRS' stated focus on R&D Tax Credits, both practitioners and taxpayers are often concerned about the sustainability of credits. We have broken down these audit questions into three distinct categories:

• **Audit Occurrence** – Often times when I am discussing a company's ability to claim the R&D Tax Credit, the CPA or client asks, "Will claiming the R&D Tax Credit trigger an IRS audit?" Often times, my answer is "maybe." Anytime a company files an amended tax return requesting a refund, there is a chance that the IRS is going to scrutinize it. We advise our clients that there is less than a 20 percent chance that the claim will be audited, based on our experience. It is important to note, that reviews of claims for refunds based on R&D Tax Credits rarely extend beyond an audit of the R&D Tax Credit. While the IRS could extend an audit beyond just the credit, in our experience, this very rarely occurs. It is also important to distinguish between claims for refunds and R&D Tax Credits claimed on current year tax filings. R&D Tax Credits claimed on original filings are reviewed much less frequently.

• **Agent's Experience** – Over the last few years we have more and more frequently found ourselves working with an agent that has little experience with the R&D Tax Credit and what constitutes as qualified research. This isn't a knock on the IRS or the agents, but is simply a result of their workload and size of the tax code. We have found that proactive communication, thorough IDR responses, and patience with the auditor are the standard ingredients for successful resolution with the IRS right now. The secret ingredient is an obvious one – do the necessary due diligence before the credit is claimed on the tax return. We have heard many horror stories of CPAs having to chase down the engineering report from the specialty tax provider. The report should be done before the client pays the invoice.

• **Substantiation** – Nexus has become the most critical and challenging requirement to substantiating tax credit claims. As we have seen with court cases over the past few years, estimates are acceptable.

However, they must be supported with contemporaneous documentation that ties expenses to qualified activities. Oral testimony isn't enough. Sitting down with the client's CFO and allocating employees' time to qualifying activities won't pass the initial “smell test.” The client’s entire development cycle continues to provide opportunity for the R&D Tax Credit, but there must be evidence that supports an employee’s involvement in technical concept development, engineering, prototyping, testing, etc. The ability to demonstrate that all four of the qualifying criteria were met is crucial to a smooth IRS audit. One area of importance is the ability to prove experimentation took place. Not only is it one of the four qualifications, but it goes a long way in demonstrating the failures that can occur during the development cycle which proves “technical uncertainty.”

None of the above observations are revolutionary, but we wanted to remind you of the ongoing potential for IRS audits and the importance of a fresh, thorough review of a company’s annual R&D Tax Credit claim. The R&D Tax Credit continues to be a very lucrative tax benefit, especially when factoring in applicable state credits. Please don’t hesitate to contact McGuire Sponsel to discuss a particular client opportunity or past claims that may create exposure under audit.