Industry Insights

Risks & Concerns for A&E Firms Claiming Federal R&D Tax Credits

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Note: Much of the following was excerpted from IRS-released discussion documents; we have added clarifying text.

The federal research & development (R&D) tax credit was created by Congress in 1981 as an incentive to increase U.S. R&D spending. The federal credit has been extended 15 times and is expected to be extended again, either temporarily as in previous years or permanently as many hope. Historically, the credit has been claimed by manufacturers and software developers. Within the last few years it has become a hot topic among architecture and engineering (A&E) firms. Although some research credit service providers claim the R&D credit is a "slam dunk" for A&E firms, taxpayers should note areas of potential risk.

Research credits are driven by wage, supply and contract research expenses related to qualified research activities. For an activity to qualify, it must meet four requirements:

- Research must have been undertaken to discover information, the application of which is intended to be useful in the development of a new or improved business component. A business component is any product, process, technique, formula, invention or software item.
- Research must be technological in nature—it must rely on the principles of the "hard sciences," *e.g.*, engineering, computer science, biology, chemistry or physics.
- Uncertainty regarding the development or improvement of a business component must exist at the outset of the project.
- A process of experimentation must be used to eliminate the uncertainties.

A key factor in determining whether the taxpayer qualifies for the R&D credit is the business component test. According to Internal Revenue Code (IRC) Section 41, research must have been undertaken to discover information, the application of which is intended to be useful in the development of a new or improved business component. A "business component" is a product, process, technique, formula, invention or software item.

The document "NSAR 020350, Vaughn" discusses the issues pertaining to a business component in more detail:

> "Where the taxpayer provides consulting services, it provides advice for use in the client's trade or business, not its own. While it may be true that the taxpayer's trade or business is giving advice, §41 requires that the "product, process," etc. be held for sale by the taxpayer or used by the taxpayer in its trade or business. ***This requirement is not met with respect to _____'s contracts that involve design work or consulting services***. [Emphasis added] Thus, we conclude that, in addition to our conclusions regarding funding, except for the _____ and _____ contracts, the requirements of Section 41 are not met because of lack of a business component."

A&E firms need to carefully consider what their "business component" is in light of this statement as well as the implications that may arise in an IRS exam.

The degree of uncertainty is another key factor in the consideration of whether the activities will qualify as R&D. More uncertainty in a project leads to more experimentation, and thus the case for R&D qualification becomes stronger. When a design has only a few minor changes and is similar to what the business has already done, the argument for R&D qualification becomes weaker. Uncertainty related to the appropriate design of the business component satisfies the uncertainty requirement; however, it is a considerably weaker type of uncertainty when compared to uncertainties regarding capability or method. Applied to A&E firms, it appears that the uncertainty does not necessarily lie in the capabilities or methods used to design a project, but in the optimal or final design of a project.

A&E activities that may qualify as research activities include technically innovative A&E designs that a firm develops for its clients or the development of innovative assembly or construction methods that accelerate or improve the construction process. Recall that "research relating to style, taste, cosmetic or seasonal design factors" is specifically identified as nonqualified. A&E activities that can potentially qualify as R&D include:

- Experimenting with new material not specifically developed or intended for an application
- Integrating new material to improve techniques, processes or formulas
- Analyzing functional requirements
- Performing engineering to evaluate new or improved specifications/modifications in terms of function, performance, reliability, quality and durability
- Development of prototypes or models
- Conceptual design, testing and modification of possible technique, process or formula alternatives

A&E firms should always be mindful of the exclusion related to funded research, as this provision can cause otherwise qualified expenditures to become nonqualified. Research performed for a customer under a contract is considered funded if either of these statements hold true:

- The amounts payable under the agreement are not contingent on the success of the research.
- The taxpayer does not retain substantial rights in the research.

According to IRC §41, funded research includes research in which the taxpayer does not retain any rights to the results, even if the taxpayer is financially at risk for the research.

Contracts ultimately are used to determine financial risks and ownership rights and usually are requested as documentation during IRS examinations. In "NSAR 020350, Vaughn," the IRS states that contracts are not considered contingent on the success where the standard of performance is that of a similar design professional exercising due care—a normal standard of care. Where the contract requires substantial performance, warrants results or is governed by local law that applies a warranty of results standard, the contract is considered contingent on results and therefore not funded.

"LAFA 20121401F" addresses a request by the IRS for legal counsel to provide guidance regarding whether work performed by the taxpayer under certain contracts would be deemed "funded" by third parties and, as a result, not allowed for the research tax credit. Although "LAFA 20121401F" is heavily redacted, the following are excerpts from the document related to several of the taxpayer's contracts:

Project 1 – Project Number 1 is funded to the extent the taxpayer is not reimbursed for its expenses because payment is not contingent on the success of the research. The contract is a cost-plus-fixed-fee contract; the taxpayer will be reimbursed for costs up to the ceiling of $[Redacted Text]. The taxpayer contractual obligation is to perform satisfactorily, which is a promise to use a [normal] standard of care. This does not imply a warranty or guarantee the success of a project. Even if the taxpayer defaults on the contract, the taxpayer will be reimbursed for the work performed.

Project 2 – Under Project Number 2, payment to the taxpayer is not contingent on the success of the research because taxpayer will be reimbursed for work performed regardless of whether the research is successful. Project 2 is a fixed-fee contract, under which the taxpayer will invoice Client 2 monthly. Upon completion of the contract, Client 2 will pay retained amounts if the work is acceptable. Thus, the taxpayer could receive payment even though Client 2 ultimately deems the work unacceptable.

Because the taxpayer must correct any deficiencies in its work without additional compensation pursuant to the warranty and the compensation is capped, the taxpayer could be at risk for any amounts over the fixed fee or for expenditures incurred during the correction of deficiencies in its work.

Project 3 – Here, payment to the taxpayer is not contingent on the results of the research. Project Number 3 relates to a capped time-and-materials contract. The taxpayer does not warrant its work, and there are no acceptance or inspection requirements. If the taxpayer incurs expense in excess of the cap, it will assume the risk for such amounts.

Project 4 – Under Project Number 4, payment to the taxpayer is not contingent on the success of the research. This is a capped time-and-materials contract. The contract is essentially for services and not the results of the research; the taxpayer offers only to perform to a [normal] standard of care and does not warrant its work. In addition, the contract does not include

acceptance or inspection requirements. However, as is the case with other capped time-and-materials contacts, taxpayer expenditures in excess of the cap may be at risk.

Project 5 – Here, all rights to "research" are retained by Client 5. Accordingly, the contract is funded. Regarding the burden of risk, it would appear that payment is contingent on the approval of services. If a work order is not completed and approved, Client 5 can withhold payment. If the taxpayer defaults, the taxpayer could be liable for additional costs incurred by Client 5 for the completion of the contracted work. As noted, however, the contract is considered funded because the taxpayer does not have a substantial right to the research.

Project 6 – Project Number 6, a capped time-and-materials contract, is funded because payment to the taxpayer is not contingent on the results of the research. Although work must be deemed satisfactory prior to payment, the taxpayer will be paid in the event of defaults under the termination/cancellation terms of the contract. Further, the taxpayer does not offer a warranty for the work provided. If the taxpayer incurs costs over the capped amount, such expenditures may be included in the credit calculation, provided the other provisions of Section 41 are satisfied.

Project 7 – Project Number 7 is a fixed-fee contract, where payment is not contingent upon the success of the research. Even if the taxpayer defaults, the taxpayer will receive payment from Client 7. In addition, the taxpayer only warrants ordinary care and skill. Although Client 7 may perform evaluations of the services provided, such evaluations will only be used for further solicitations. As is the case with other capped or fixed-fee contracts, the taxpayer may be at risk only for amounts incurred over the cap.

A&E firms should carefully evaluate contracts to determine if projects fall under the funded research exclusion. Projects should only be included as qualified research activities if they have contracts where:

- Payment is contingent on success, as indicated by all of the following:
  - Meeting specific technical criteria
  - Uncapped warranty liability or requirement for a technical performance bond
  - Nonperformance termination provisions leaving taxpayer at risk for its expenses
- The taxpayer owns substantial rights to the research results

A&E firms also should note that certain fixed-fee and capped time-and-materials contracts may be partially funded and that they may be eligible to claim credit only for qualified costs incurred over the capped amount.

A&E firms should proceed with caution when exploring the opportunity to take advantage of R&D credits. The guidance provided in "NSAR 020350, Vaughn" and "LAFA 20121401F" is nonbinding; however, it provides significant insight into the potential issues for taxpayers in this industry. A&E firms claiming research credit should document the qualified nature and amount of the research included in research credit claims, and they should be prepared to provide contracts exhibiting payment and warranty/guarantee terms and ownership rights to the research results.

If you have claimed research credits, or if you think you have qualified research expenses and should claim the credits, contact your BKD advisor to learn more.