

# IRS ADDRESSES FREQUENTLY ASKED QUESTIONS REGARDING RESEARCH CREDIT DIRECTIVE

## Summary

The FAQs address questions asked by taxpayers who either have adopted the Directive or are considering doing so.

The questions relate to a host of topics, some of which are discussed below under “Detail.” They include: Accounting Standards Codification (ASC) 730; certain software development activities; certified audited financial statements; the Directive and its Appendices; the ways in which the Directive interacts with other IRC sections; substantiation; audit steps under the Directive; and penalties.

The FAQs explain that the Directive does not “determine as a matter of law” that ASC 730 research activities are Research-Credit qualified activities. Instead, its purpose is only to improve the efficiency of Research-Credit examinations, not to establish legally conclusive presumptions.

For further guidance, taxpayers should review the Directive itself, along with the Practice Units recently released by the IRS.

## Detail

The IRS released [Frequently Asked Questions](#) (FAQs) regarding its Large Business & International (LB&I) division’s [Research Credit Directive](#) released last September (Directive). The FAQs are intended to clarify the methodology the Directive follows and the costs it allows.

The Directive allows a safe harbor for certain costs and provides guidance to examiners concerning examinations of Internal Revenue Code (IRC) Section 41 credits for increasing research activities (Research Credit). It applies only to LB&I taxpayers—i.e., taxpayers whose assets equal or exceed \$10,000,000—who follow U.S. Generally Accepted Accounting Principles (GAAP) to prepare their Certified Audited Financial Statements and who show, as a separate line item or in a separately stated note to their Certified Audited Financial Statements, the amount of their currently expensed ASC 730 R&D costs.

The FAQs provide a welcome elaboration of many items contained in the Directive. Like the Directive, however, they are not an official pronouncement of law and cannot be used, cited, or relied on as such.

## Certified Audited Financial Statements

The FAQs clarify that the Directive does not apply to taxpayers who prepare their Certified Audited Financial Statements following International Financial Reporting Standards, only to those who follow GAAP.

A taxpayer may still have to report an Uncertain Tax Position for the Research Credit if it: (1) reports additional qualified research expenses (QREs) from either ASC 730 accounts not included in the Adjusted ASC 730 Financial Statement R&D (ADJ 730 FS R&D) or from non-ASC 730 accounts; or (2) is uncertain about the types of accounts included or excluded in the ADJ ASC 730 FS R&D amounts.

**Effective Date**

The Directive applies only to original returns filed on or after September 11, 2017. Neither amended returns nor Research Credits carried forward from tax returns originally filed prior to this date are eligible for the Directive's treatment. A taxpayer may subsequently choose to follow the Directive during examination, even if it did not do so when it originally claimed the Research Credit on its original return, so long as the return was filed on or after September 11, 2017.

IRS Examination teams, however, may, at their sole discretion, choose to apply the Directive to original returns filed prior to the effective date and to amended returns filed after the date.

**Software Development Activities**

The FAQs review certain software development activities, costs associated with those activities, and their appropriate accounting treatment. For the development of software for sale, lease, or market, only costs up to the point of establishing technological feasibility are ASC 730 R&D costs. Under ASC 985-20, the accounting standard for software marketed externally, "technological feasibility" is established when all of the planning, designing, coding, and testing necessary to establish that it can be produced to meet its design specifications has been completed.

Generally, the costs associated with the development of internal-use software are not included in ASC 730 R&D costs. Under ASC 350-40, internal-use software is software that is acquired, internally developed, or modified solely to meet an entity's internal needs where, during the software's development or modification, no substantive plan exists or is being developed to market the software externally.

ASC 350-40 provides (1) further guidance on accounting for the costs of developing or obtaining software for internal use, (2) examples illustrating when software is or is not for internal use, and (3) some exceptions that require accounting treatment for internal-use software under ASC 730.

**Certain Qualified Costs**

The FAQs confirm that only wages separately reported as ASC 730 R&D qualify for the Directive's safe harbor. If, therefore, an employee has wages reported both inside and outside of ASC 730 FS R&D cost centers, only those recorded as ASC 730 R&D qualify for treatment under the Directive. Taxpayers should refer to the FAQs if they have further questions surrounding wages claimed both under and separate from the Directive, as the FAQs provide detail and examples on the methodology to follow.

The "substantially all" rule under IRC 41(b)(2)(B) and Treas. Reg. 1.41-2(d)(2) provides that if at least 80 percent of an employee's activities during the taxable year meet IRC 41's requirements, 100 percent of her activities are to be treated as qualified services. The FAQs, however, explain that this rule does not apply under the Directive. So, for example, if 85 percent of an employee's activities qualify, the Directive allows the taxpayer to claim only 85 percent of her wages, not the 100 percent allowed by IRC 41.

**"Consistency Rule"**

Prior to the FAQs, it was unclear whether a taxpayer electing to follow the Directive was required to re-compute its base amount or fixed-base percentage using the Directive. It does not.

The taxpayer is required to consider the types of activities and costs included in the current year and whether those same types of activities and costs were included in the base years, regardless of the methodology used.

### **Insights**

The choice to follow the Directive is a choice that a taxpayer makes tax year by tax year. The FAQs will help with this choice, answering some significant questions. Taxpayers concerned with the consistency rule, for example, can breathe a sigh of relief knowing that they do not have to re-compute their base amount following the Directive template. And taxpayers wanting further guidance regarding how to calculate qualified wages can find help in an example the FAQs provide.