

Morgan Lewis

SIXTH ANNUAL
**RESEARCH &
DEVELOPMENT
TAX CREDIT**
SYMPOSIUM

*Welcome
Remarks*

Alex Sadler, Tom Linguanti & Doug Norton | November 11, 2020
Session 2

Welcome to Session 2!

- BUT, FIRST: quick run-through of answers to Monday's quiz, followed by live raffle to pick Session 1 winners...
- REMINDER: new quiz each day; attendees completing the quiz and answering 10 questions correctly will be entered into a raffle to win one of two R&D treatises raffled each day!
- More R&D tax credit quiz fun today:
 - Will close out today's program with quiz around 3:25 pm ET
 - Answers must be submitted via WebEx
 - Raffle winners for today's quiz will be announced Friday morning



QUIZ TIME

Answers to Monday's Quiz (Session 1: Questions 1-5)

1. Which one of the following is not a qualified research expense?
Training and relocation expenses for employees engaged in research and development
2. Congress enacted the research credit and made it permanent in which of the following years:
1981 and 2015
3. Which two US states don't observe Daylight Saving Time?
Arizona and Hawaii
4. The consistency requirement codified in section 41(c)(6) is applied at which of the following:
The legal entity level
5. The definition of qualified research codified in section 41(d)(1) is applied at which of the following:
The business component level

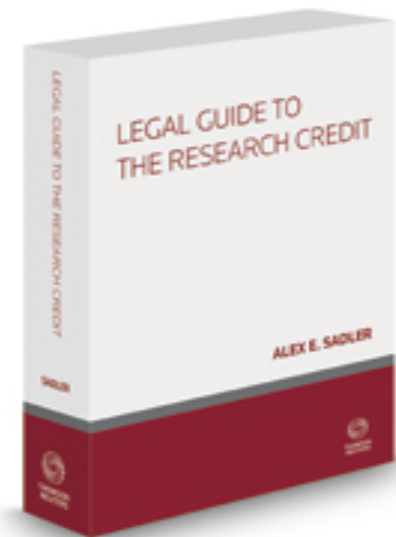
Answers to Monday's Quiz (Session 1: Questions 6-10)

6. Lateral Epicondylitis is a condition commonly known by what name?
Tennis Elbow
7. In which case did the Tax Court sustain qualified service percentage allocations based largely on the testimony of the taxpayer's vice president for product development?
Suder
8. A taxpayer may make an election of the Alternative Simplified Credit under section 41(c)(5) on an amended return if it has not previously claimed the regular credit and the statute of limitations on assessments remains open.
True
9. Which country is known as the Land of White Elephant?
Thailand
10. Before the Beatles were formed, John Lennon, Paul McCartney and George Harrison were originally members of which group?
The Quarrymen

And Monday's Session 1 raffle winners are...



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Wednesday's Program – November 11, 2020

12:00 pm – 12:15 pm	Welcome Remarks Morgan Lewis: Alex Sadler, Doug Norton, and Tom Linguanti
12:15 pm – 1:15 pm	Special Issues with Pilot Models and Heavy Supply Cost Claims Alvarez & Marsal Taxand: Kathleen King
1:15 pm – 1:20 pm	BREAK
1:20 pm – 2:20 pm	R&D Technical Update: Recent Cases and Trends alliantgroup: John Dies alliantgroup: Jeremy Fingeret
2:20 pm – 2:25 pm	BREAK
2:25 pm – 3:25 pm	Current Environment for Software Development Claims Andersen: Caitlin Bradley Capital One Financial Corporation: Brian Kaufman Morgan Lewis: Tom Linguanti Tanner: Shawn Marchant
3:25 – 3:30 pm	Quiz
5:00 pm – 6:00 pm	Informal Networking Session with Panelists and Attendees

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**VIRTUAL HAPPY HOUR
5:00 PM ET WITH
SPEAKERS AND ATTENDEES**

**BRING QUESTIONS, COMMENTS, AND A
BEVERAGE OF YOUR CHOICE!**



PEOPLE WHO MAY OR MAY NOT BE ATTENDING TODAY'S VIRTUAL HAPPY HOUR...



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RESEARCH & DEVELOPMENT TAX CREDIT

SYMPOSIUM

NOVEMBER 11, 2020

Special Issues with Pilot Models and Heavy Supply Cost Claims

Kathleen King, Alvarez & Marsal Taxand

Presenter



Kathleen King
Managing Director and National R&D Practice Leader
Washington, DC

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Special Issues with Pilot Models and Heavy Supply Cost Claims

- Section 01
 - Technical Guidance
- Section 02
 - Practical Considerations for Identifying and Documenting Heavy Supply Costs
- Section 03
 - Supply Cost Case Studies

SECTION 01

TECHNICAL GUIDANCE

Section 174 – The Basics

Treas. Reg. §1.174-2(a)(1) defines research or experimental expenditures as research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.

Uncertainty must exist

Depends on the nature of the activity to which the expenditures relate

Ultimate success, failure, sale, or use of the product is not relevant

Costs may be eligible after production begins but before development uncertainty is eliminated

Section 174 – The Basics (continued)

- The 2014 amendment to the Section 174 regulations added the definition of a pilot model.
- The term “pilot model” means any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product.
 - The term product includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.
- “Pilot model” includes a fully functional representation or model.
- Because the definition of pilot model is relatively new, its meaning has not been litigated or otherwise expounded upon by the courts.

Section 41 – The Basics

- The term “in-house research expenses” means — any amount paid or incurred for supplies used in the conduct of qualified research.
- The term “supplies” means any tangible property *other than*:
 - land or improvements to land, and
 - property of a character subject to the allowance for depreciation.

Used in the Conduct of Qualified Research

- **Qualified research is an activity that meets the four-part test**
 - The purpose of the research must be to achieve improved functionality, performance, reliability, or quality.
 - The activity must be undertaken for the purpose of discovering information that is technological in nature.
 - The activity must meet the definition of qualifying research under Code Section 174 and must be eligible for expense treatment.
 - Research intends to eliminate uncertainty concerning the development or improvement of a product.
 - Substantially all activities must constitute elements of a process of experimentation.

Polling Question #1

What year was Section 174 originally enacted?

- A. 1954
- B. 1965
- C. 1973
- D. 1981

Property of a Character Subject to Depreciation

- Meaning of “property of a character subject to the allowance of depreciation” was addressed in multiple court cases.
- TG Missouri, 133 T.C. No. 13 (November 12, 2009) –
 - Claimed molds designed and sold to customers.
 - Court concluded that the production molds sold were not assets subject to depreciation for purposes of claiming as §41 and §174 and qualified for credit.
- Trinity Industries, 105 ATFR 2d 2010 (N.D. Tex. 2010, January 29, 2010) –
 - District Court’s decision was consistent with the Tax Court’s pro-taxpayer findings in TG Missouri (government dropped “property of a character ...” argument).
 - Court confirmed that integration costs qualify.
 - Holistic view of business component.

Other Relevant Court Cases

- Union Carbide, No. 11-2552 (2d circuit 2012).
 - Taxpayer was not entitled to supply expenses related to manufacturing process research.
 - “Indirect” v. Direct costs of research.
- Siemer Milling, T.C. Memo 2019-37.
 - Company in the business of milling and selling wheat flour failed to prove qualified research occurred.
 - Cited UCC regarding “methodical plan involving a series of trials.”

SECTION 02

**PRACTICAL
CONSIDERATIONS FOR
IDENTIFYING AND
DOCUMENTING HEAVY
SUPPLY COSTS**

Defining Prototypes and Pilot Models

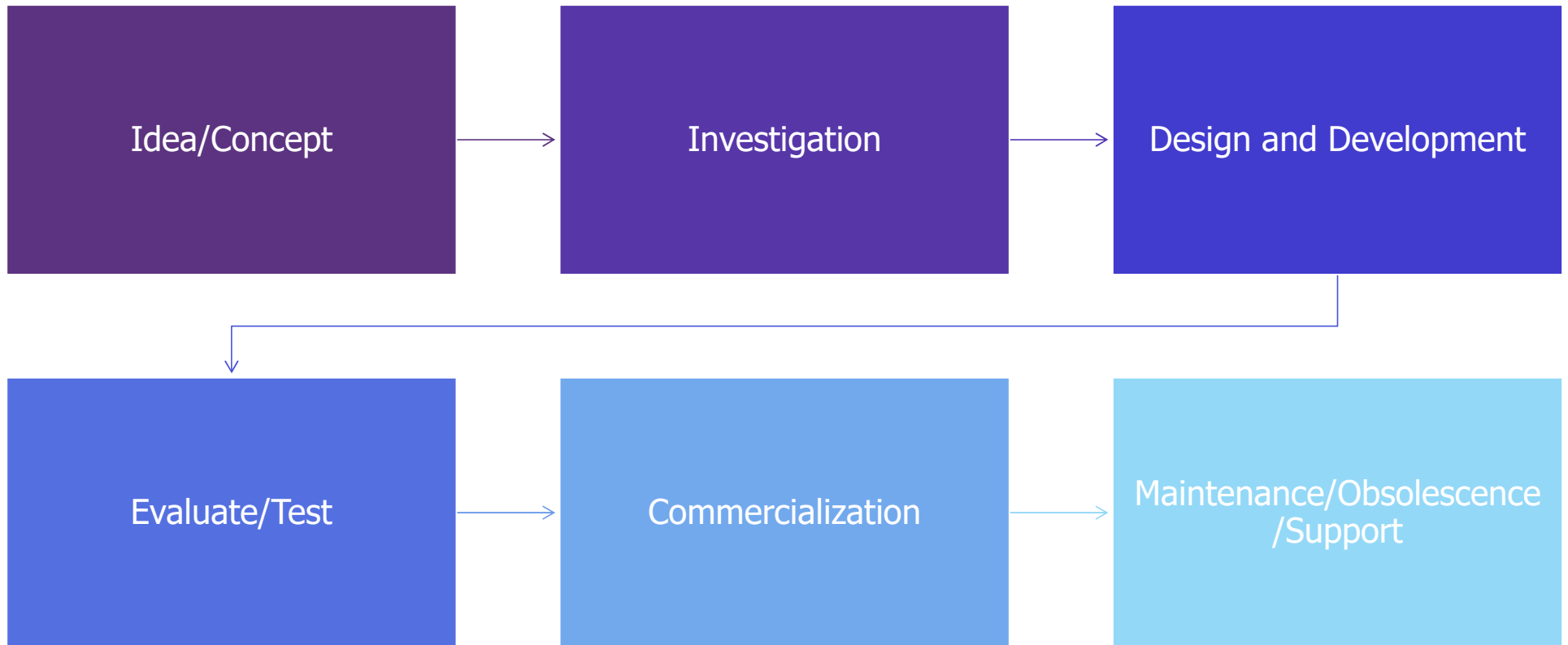
- Oxford – Prototype Definition
 - A first, typical or preliminary model of something, especially a machine, from which other forms are developed or copied.
- Merriam-Webster – Prototype Definition
 - A first full-scale and usually functional form of a new type or design of a construction (such as an airplane).
- Pilot Model defined under Section 174
 - Any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product.
 - “Pilot model” includes a fully functional representation or model.

Polling Question #2

Which R&D credit court case primarily focused on the “property of a character ...” issue?

- A. Trinity
- B. T.G. Missouri
- C. Suder
- D. Union Carbide

Prototypes and the Development Lifecycle



Approaches to Support Supply Costs

- Describe how the supplies are used in the performance of qualified services.
- Identify the individuals “using” the supplies in research.
- Describe how the supplies differ from normal production.
- Describe tax accounting policies for expenses (expense vs. capitalize).
- Document the disposition of supplies after the research process is complete.
- Describe how science drives the location and size of the research.

Approaches to Support Supply Costs - continued

- Give examples of failures, overruns, iterations.
- Factually distinguish the costs and activities from normal production.
- Consider how business facts support the position
 - Are they labeled as “prototype”, “first article” or “pilot”?
 - How do they differ from prior versions of the product?

Polling Question #3

Which of the following statements is true?

- A. Supply costs cannot be claimed if they are intended sale.
- B. Prototypes must be built in a lab in order to qualify.
- C. Supply costs can only be claimed on the first three prototypes.
- D. Supply costs qualify if they come from outside the U.S.

SECTION 03

SUPPLY COST CASE STUDIES

SUMMARY

CASE STUDY: DRONE BATTERY

ISSUES ADDRESSED

- Product component redesign
- Sale of good produced in research
- Multiple prototypes
- Types of qualifying costs

DETAILS

- Y is a manufacturer of drones. Y is researching and developing a new type of battery to improve the performance of the existing battery design that Y already manufactures and sells in its drones. To test the appropriate design of the new battery and evaluate its impact on the performance of the drone, Y produces and installs the battery on a drone.
- What costs related to the production the drone with the new battery will qualify as research and development costs in the experimental or laboratory sense?
- Does the answer change if the drone is sold?
- Do the costs of the drone qualify if it was taken out of inventory?
- If Y produced 20 different drones with the new battery, what costs will qualify?

Polling Question #4

What type of QRE do you spend most of your time supporting during an IRS exam?

- A. Wages.
- B. Supplies.
- C. Contract Research.
- D. All of the above.

SUMMARY

CASE STUDY: IMPROVED PROCESS

ISSUES TO CONSIDER

- Process v. product improvement
- Sale of a product
- Size of project

DETAILS

- Z is a wine producer. Z is researching and developing a new wine production process that involves the use of a different method of crushing the wine grapes. In order to test the effectiveness of the new method of crushing wine grapes, Z incurs \$2,000 in labor and materials to conduct the test on this part of the new manufacturing process.
- Does the \$2,000 of labor and materials qualify as research or experimental expenditures?
- Does the conclusion change if the minimum cost to produce the batch of wine using the new method is \$200,000?
- If the company requires at least 3 verification tests before they can approve the project, how many tests will qualify?
- If the R&D department is changing the flavor profile of the wine in addition to the process, how does it change the analysis?

Biography



Kathleen L. King

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Kathleen King, a managing director of A&M Taxand, has over 25 years of experience advising corporate clients on federal tax matters. Her experience includes helping clients claim, document and sustain tax incentives, including federal and state research tax credits, investment credits, fixed asset treatment and meals & entertainment deduction. Kathleen's projects range from targeted consulting engagements designed to address a specific issue to large scale projects utilizing engagement teams working concurrently in multiple locations.

She has advised clients in a variety of industries including aerospace and defense, food products, manufacturing, financial services, pharmaceutical products, and IT/software. Prior to joining A&M, Kathleen served as a National Office for the Research Credit Services team at Big Four accounting firms. She has written numerous articles and regulatory comments on the research credit and is a frequent speaker on research credit issues.

Kathleen earned her bachelor's degree in Mineral Land Management from the University of Colorado and her master's degree in Accounting from American University in Washington, D.C. She is a certified public accountant.

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SYMPOSIUM

NOVEMBER 11, 2020

R&D Technical Update: Recent Cases and Trends

John Dies, Managing Director of Tax Controversy, alliantgroup

Jeremy Fingeret, Chief Quality Officer, alliantgroup

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Presenters



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**Former IRS
Commissioners:**

MARK W. EVERSON

STEVEN T. MILLER

KATHY PETRONCHAK

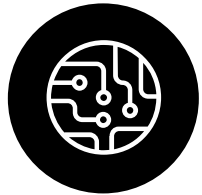
**150+ TAX
ATTORNEYS**



**Former
Counsels
to the
Senate
Finance
Committee:**
DEAN ZERBE
DAWN LEVY

**ARCHITECTS | ENGINEERS | CHEMISTS |
BIOLOGISTS SOFTWARE DEVELOPERS | PhDs**

R&D TAX CREDIT LITIGATION EXPERIENCE:



United States v. McFerrin,
570 F.3d 672 (5th Cir. 2009)



United States v. Quebe,
3:15-cv-294 (S.D. Ohio 2019)



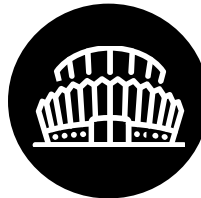
Shami v. Commissioner,
741 F.3d 560 (5th Cir. 2014)



Audio Technica U.S., Inc. v. United States,
5:16 cv 02052 (N.D. Ohio 2019)



Suder v. Commissioner,
T.C. Memo 2014-201
(2014)



Populous Holdings, Inc. vs. Comm'r,
Docket no. 405-17 (2019)

More opinions soon to follow...

AGENDA

- Recent Case Law:
 - *Suder vs. Comm’r*, T.C. Memo 2014-201 (US Tax Court)
 - *Audio Technica vs. Comm’r*, Case: 5:16-cv-02052-JRA; (Fed. Dist. Ct. Northern OH)
 - *Populous Holdings vs. Comm’r*, Docket No. 405-17 (US Tax Court)
 - *Siemer Milling vs. Comm’r*, T.C. Memo 2019-37 (US Tax Court)
 - Sneak Peak: *Little Sandy Coal Co. (Corn Island Shipyard)* (US Tax Court) and More on the Horizon...
- Defending Taxpayers: Tactics and Approaches
- The Secret Sauce

Recent Case Law:

Suder vs. Comm'r

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Recent Case Law: *Suder vs. Comm'r*

- Pertinent Facts:
 - Estech Systems, Inc. (ESI) Designs and Develops VOIP Phone Systems for Businesses. ESI Filed in the US Tax Court for Credit Years 2003 to 2007. alliantgroup Conducted an R&D tax credit study for ESI.
 - ESI's R&D included the Development of: Circuit Boards, Call Processing Software (dial tone, call waiting, automated call distribution), Wireless Phones, Phone Systems, etc.
 - QREs were Identified for Wages, Supplies and Contractor Costs
 - Wages: President, VP, Engineers, Sales, Tech Support, Warehouse Assistants, Purchasing and more...
 - Contractors: Outside Testing, Circuit Board Design and Patent Attorneys
- The Issues in Dispute
 - "Routine Engineering" – Government Argued that Avaya Made Similar Systems for Years
 - Dev. Work Based Upon Existing and Available Knowledge
 - The Scope and Extent of Wages Allocable toward the Credit
 - Allocation of Other QREs
 - Reasonableness of Officers Compensation
 - Substantiation

Recent Case Law: *Suder vs. Comm'r*

- **“The Research Tax Credit is one of the most complicated provisions in the Code.”** Judge Vasquez
- The Findings / Resolution by the Court - - **A HUGE VICTORY FOR TAXPAYERS!!**
 - Project Qualification
 - Routine Engineering (Dr. Charles Jackson) – The Taxpayers May Rely Upon Known Engineering Principles. Reg. 1.41-4(a)(5)(i). There is no Distinction between Engineering Principles and “Engineering Know-How”
 - Use of Data Sheets, Design Manuals, Online Materials and General Information is fine. Taxpayers do NOT have to “Reinvent the Wheel”
 - Allocable Wages
 - In addition to Engineers – Employees with non-traditional titles were allocated toward the R&D tax credit: sales, tech support, warehouse, purchasing, etc. – The Court Approved 100%
 - Supply and Contractor QREs
 - Patent Attorneys – 100% Approved

Recent Case Law: *Suder vs. Comm'r*



- The Findings / Resolution by the Court
 - Reasonable Compensation – A Case of First Impression
 - Substantiation
 - IRS Argued that “Petitioners neither substantiated the QREs claimed nor produced sufficient evidence for this Court to make reasonable estimates for QREs.”
 - The Court Disagreed with the IRS
 - Petitioners produced Exhibit 445-P –
 - Petitioners Prevailed! Using the Proper Combination of Documentary Evidence properly coordinated with Testimony from Knowledge Technical Personnel Established the proper Substantiation to Support the Credits! **Detailed Technical Analysis!**
 - 11 of 12 Projects Were Qualified and Sustained by the Court

Recent Case Law: *Suder vs. Comm'r*



- The IRS Playbook Didn't Work in this Case:
 - Dumb Down and Over Simplify the Facts of the BCs
 - Dr. Charles Jackson, Ph.D. from M.I.T.
 - Avaya Has Done It All Before
 - Minimize the Contributions of the Employees
 - Oh, These Guys Are Just...
 - Engage in the War of Adjectives – It's All "Easy"
 - Keep Arguing the Discovery Rule (Just Give It A Different Name)

Polling Question 1

The IRS will often downplay taxpayer facts (for example, calling taxpayer's work "routine" or dismissing wage allocations based upon job titles). Have you ever had the IRS downplay facts in an examination?

- Yes
- No

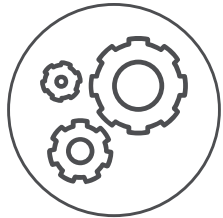


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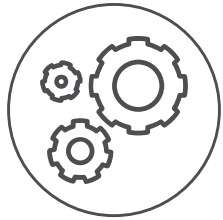
Recent Case Law:
Audio Technica vs. Comm'r

Recent Case Law: *Audio Technica vs. Comm'r*



- Pertinent Facts:
 - Audio Technica is a Premier Designer of Microphones, Speakers and Electronics. They have made microphones for NFL, Olympics, Congress, Professional Singers, etc.
 - AT Designed New Technologies for Use in Mics, etc.
 - alliantgroup conducted an R&D tax credit study for AT
 - First Ever R&D Credit Case Tried to Jury
- The Issues in Dispute
 - IRS Claimed the Taxpayer Didn't Meet the 4-Part Test (No Process of Experimentation, Business Components, Uncertainties)
 - Exclusions (Adaptation, Duplication, Foreign Research)
 - Routine Engineering

Recent Case Law: *Audio Technica vs. Comm'r*



- The Art of War:
 - How Does One Present Highly Complex and Fact Intensive Issues to a Jury?
 - Summarizing Voluminous Evidence
 - Visualizing a Process of Experimentation
 - Showing the Time Spent on R&D
 - The Construction of Dozens of Visual Aids

Recent Case Law: *Audio Technica vs. Comm'r*



- Due to the Involvement of a Jury – The Evidence Had to Be Spoon-fed
 - 27 Demonstrative Aids Led the Charge!
- The Findings / Resolution by the Court
 - *The Jury Unanimously Found That All 5 Business Components Involved QRAs.*
 - *The Jury Unanimously Found That Audio Technica Conducted Research in all 5 Years.*
 - *The Jury Unanimously Found that Audio Technica incurred Qualified Research Expenditures in all 5 Years.*

Polling Question 2

Have you considered the advantages and disadvantages of different jurisdictions wherein an R&D tax credit case could be tried (for example the U.S. Tax Court vs. a jury trial in Federal District Court)?

- Yes
- No

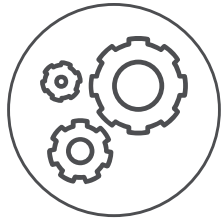
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Recent Case Law:

Populous Holdings vs. Comm'r

Recent Case Law: *Populous Holdings vs. Comm'r*

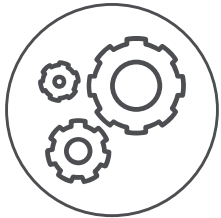


Introduction to Populous:

Since Its Founding in 1983, Populous Holdings (Formerly Known as HOK Sport) is an Architecture Firm That Has Been a Global Leader in Designing Some of the World's Most Memorable Sports, Civic and Entertainment Buildings Including Over 1,325 Stadiums (Texans, Cardinals, etc.), 90 Global Events Venues Home - To 12 Olympic Games, the 2014 FIFA World Cups, and 34 NFL Superbowls.

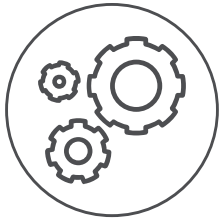
Recent Case Law: *Populous Holdings vs. Comm'r*

The Funded Research Exclusion



- Filed Before the U.S. Tax Court – the Court Found for the Taxpayer on Summary Judgment
- The Parties Agreed to Limit the Case to the Funded Research Exclusion
- The IRS Argued:
 - Contracts Had No Mechanism To Refuse Payment.
 - Payment Was Not based on Acceptance of Populous' Work.
 - Additional Services Received Additional Pay.
 - Populous Services Met the Professional Standard of Care.
 - Populous's Clients Owned the Documents Created.

Recent Case Law: *Populous Holdings vs. Comm'r*



The Funded Research Exclusion

The Taxpayer Countered These Arguments As Follows:

- Fixed Fee Contracts Have Inherent Risk (See Fairchild and Geosyntec.)
- Acceptance Clauses Created Risk.
- Payments Schedules Don't Release Risk.
- The Contract for Architectural Services Was for a Final Design.
 - The IRS Cannot Ignore Populous's Primary Requirement Under the Contract

Recent Case Law: *Populous Holdings vs. Comm'r*



The Court's Findings

The Court Ultimately Found as Follows:

- None of the Contracts Expressly Required Research.
- Petitioner Was Paid for a Work Product.
- Fixed Fee Contract Have Inherent Risk.
- Petitioner Bore the Risk of Failure.
- The Ownership of the End Documents Was Not Determinative As To Substantial Rights.

Polling Question 3

The “funded research” exclusion has been a primary IRS argument for a number of years. Have you ever had the IRS claim that non-funded business components are, in fact, funded?

- Yes
- No

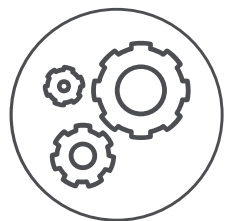
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Recent Case Law:

Siemer Milling vs. Comm'r

Recent Case Law: *Siemer Milling vs. Comm'r*



- Pertinent Facts:
 - Siemer Milling Mills and Sells Wheat Flour.
 - Clifton Larson Allen performed an R&D tax credit study.
 - 7 R&D projects were presented to the U.S. Tax Court. Examples:
 - Flour Heat Treatment Project: Heated batches of wheat to different temperatures.
 - Pulsewave Project: SM purchased a pulsewave machine in 2010 and were adjusting settings on the equipment to determine different effects on their manufacturing process.
- The Issues in Dispute
 - IRS Claimed projects didn't Qualify (failed to meet 4-Part Test).
 - IRS Claimed SM Failed to Have Employees with Formal Science Degrees.
 - IRS Argued that Different Uncertainties Must be found in Each Year.

Recent Case Law: *Siemer Milling vs. Comm'r*



- The Findings / Resolution by the Court
 - The Taxpayer Lost on All 7 Projects. The Court Found that Basic Elements of the 4-Part Test (New or Improved Business Component, POE, Uncertainty and Technological in Nature) were missing on each project.
 - The Commissioner argued that the “record was devoid of evidence that petitioner formulated or tested hypotheses, or engaged in modeling, simulation, or systematic trial and error.”
 - Court found that “there was little in the record to support (Petitioner’s) assertion. Even the credit studies for the years in issue, which were admitted...included very little evidence of Siemer’s asserted process of experimentation.”

Recent Case Law: *Siemer Milling vs. Comm'r*



- The Legal Holdings Were Spot On!
 - The Court Properly Applied the 4-Part Test
 - The Court Shot Down the IRS Argument that the Taxpayer's Employees Needed Science Degrees.
 - The Court Shot Down the IRS Argument that Different Uncertainties Were Needed in Each Year.
 - The Evidence and Information, as presented, Did Not Meet the Legal Elements and Requirements to Qualify Under IRC Sec. 41

Recent Case Law: *Siemer Milling vs. Comm'r*

- Pertinent Facts:
 - LSCC is the Parent Company to the Corn Island Shipyard (CIS)
 - CIS Designs and Constructs inland barges in Indiana.
 - CIS Claimed R&D Credits for 11 Vessels.
 - U.S. Tax Court (Judge Halpern) Tried the Case Based Upon 2 Vessels in April 2019. No Opinion Has Yet to Be Issued.
- The Issues in Dispute
 - Qualification of the Projects (3 of 4 Elements, IRS Conceded Tech in Nature)
 - Supply QREs (IRS Contesting Supplies Were Part of Commercial Production)
 - **Adaptation, Routine QC and Research After Commercial Production Exclusions**
- TCBW and LMI Are Soon To Come As Well...

Polling Question 4

Following the *Siemer Milling* opinion, the IRS has started arguing that some manufacturers are performing work that is simple trial and error and, therefore, not qualified. Have you seen the IRS making these arguments?

- Yes
- No

Defending Taxpayers: Tactics and Approach

- The R&D Tax Credit is Extremely Fact Intensive. Legal Elements Require Proving:
 - The Process of Experimentation followed on Each Independent Qualified Research Projects (Some Companies Have 100s or 1,000s of Projects)
 - This includes Design Iterations and Alternatives
 - Qualification for Each Business Component Must be Done Independently. *Treas.Reg. 1.41-4(b)(1)*
 - The Activities Contributed by Individual Employees (Can Be 100s or 1,000s of Employees)
 - Historical Periods: Base Period Potentially From the 80s or 90s up to Today
 - Exclusions: Adaptation, Duplication, RACP, Etc.

Defending Taxpayers: Tactics and Approaches

Suder vs. Comm'r	Audio Technica	Siemer Milling	Little Sandy Coal
<p>Number of Projects: 12</p> <p>Documents: 170,000+</p> <p>Taxpayer Exhibits: 430+</p> <p>Witnesses: 18</p> <p>12 Engineers, Software Developers and Techs</p> <p>2 Owners</p> <p>1 CPA</p> <p>3 Experts</p>	<p>Number of Projects: 5</p> <p>Documents: 549,000+</p> <p>Taxpayer Exhibits: 158 (27 Demonstratives Aids Summarizing Evid.)</p> <p>Witnesses: 7</p> <p>5 AT Engineers and Technical Personnel</p> <p>1 AT Controller</p> <p>1 IRS Engineer</p>	<p>Number of Projects: 7</p> <p>Taxpayer Exhibits: 94 without objections</p> <p>Witnesses: 6</p> <p>5 CPAs/Accountants (Internal and CLA)</p> <p>1 Company Employee with Actual Project Experience (VP of Production)</p>	<p>Number of Projects: 2</p> <p>Documents: 850,000+</p> <p>Taxpayer Exhibits: 1700+</p> <p>Witnesses: 8</p> <p>2 Company Owners</p> <p>2 Engineers</p> <p>1 R&D Expert</p> <p>2 US Coast Guard</p> <p>1 ABS Certifier</p> <p>1 Shipbuilding Industry Expert</p>

The Secret Sauce: Facts, Facts and More Facts...

- Statisticians and Data Analysts
 - *Devil is in the Details*
 - 10s, 100s or 1,000s of Projects, Employees, Supply Costs, Etc. Can be Hard to Prove
- Reasonable Compensation
 - *Suder* has added a new wrinkle!
- When Necessary – Let Lawyers Be Lawyers!
- Engineers, Biologists, Chemists, Ph.D.s and Software Experts
 - Don't let lawyers and CPAs play doctor!

Biography



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John is the managing director of tax controversy of alliantgroup. He is an experienced trial attorney and a former partner from a well-respected insurance litigation firm. Based in Houston, TX, John has been litigating insurance matters for 20 years and has represented hundreds of clients and tried multiple cases to verdict throughout the United States. John has handled hundreds of matters related to insurance and coverage issues in both first party and insurance agent malpractice claims.

John earned a JD from South Texas College of Law and a BA from the University of Houston.

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Jeremy is the chief quality officer of alliantgroup. He manages the daily operations of alliantgroup's consulting practice including R&D Tax Credit services, 179D services, IC-DISC services, tax controversy services, domestic production activities deduction services and SALT/hiring credits and incentives services. He is an experienced litigation attorney having handled many cases in multiple state and federal courts.

Jeremy earned a JD from the University of Houston Law Center and a BA from the University of Florida.

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SIXTH ANNUAL

RESEARCH & DEVELOPMENT TAX CREDIT

SYMPOSIUM

NOVEMBER 11, 2020

Current Environment for Software Development Claims

Caitlin Bradley, Director, Andersen

Brian Kaufman, Vice President, Tax Counsel, Capital One

Thomas Linguanti, Partner, Morgan, Lewis & Bockius LLP

Shawn Marchant, Principal, Tanner LLC

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CURRENT ENVIRONMENT FOR SOFTWARE CLAIMS

Polling Question #1

I have been involved in an IRS exam related to software development R&D claims

1. Yes
2. No
3. Not yet but I think it's coming
4. Not applicable

Software Development – Evolution

- A. On-premise v. Cloud-based
- B. Shorter development lifecycle
- C. Architecture
 - 1. Monolithic v. distributed
 - 2. Backend to frontend
- D. Automated testing
- E. Libraries and third-party or open-source software

Software Development – Opportunity Areas

- A. Software used in production process
 - 1. Broadly define production process - varies by taxpayer
 - a. Automating infrastructure
- B. Developing test tools, test cases used in developing or testing software
- C. Computer rental
- D. Cloud-based development
- E. Direct support
 - 1. Product / Project Managers, UI/UX, Business Analysts, Operations, IT
 - 2. Site Reliability or Production Engineer
 - 3. Preparing or maintaining documentation

Software Development – Potential Pitfalls

- A. Adaptation, e.g. version 1.1 vs. 1.2
- B. Vendor selection
- C. UX/UI, aesthetic design
- D. A/B testing
- E. Libraries and open-source software
- F. Website development
- G. Inventory management
- H. Non-US development – payment to US contractor that employs offshore developers
- I. PPP loan forgiveness – funded research
- J. Lack of documentation to support process of experimentation

External-Use, Internal-Use, and Dual Function

- A. External-Use: functions as anything other than general and administrative

- B. Internal-Use: G&A functionality to support Taxpayer's trade or business
 - 1. Financial management or record keeping
 - 2. Human Resources
 - 3. Support day-to-day operations

External-Use, Internal-Use, and Dual Function

- C. Dual-Function: serves both general and administrative functions and ability of third-party interaction
 - 1. Safe harbor: if 10% or more of software relates to 3rd party interaction; 25% will not be considered IUS (don't need to prove high threshold of innovation test)
 - a. Favorable for software developers where majority of software is IUS
 - b. Software used internally and sold, leased, or marketed is not considered dual-function
 - c. Pitfalls: substantiating the 90/10 rule

Polling Question #2

As it relates to dual-function software as defined in the internal-use software regulations:

1. I have, or my client has, claimed QREs related to dual-function software
2. I have, or my client plans, to claim QREs related to dual-function software
3. I have no experience claiming dual-function software
4. I drive a dually truck
5. Other

IRS ASC 730 Revised Directive – Impact on Software

Revised Directive issued September 10, 2020. Effective for tax periods ending on or after July 31, 2020

1. Removal of "safe harbor" language
2. Additional eligibility requirement: US GAAP for financial statement and tax return preparation
3. Heightened IRS review process - approval before requesting more documentation
4. Changes to Appendix C
 - a. Removal of Non-ASC 730 expenses from Adjusted FS R&D
 - i. ASC 350-40 IUS software
 - ii. ASC 350-50 Software
 - iii. ASC 730-10-55-2 NQ activities
5. Additional documentation - methodology memo, evidence of internal controls

Polling Question #3

I plan to use the revised ASC 730 directive to substantiate R&D tax credit claims related to software development

1. Very likely
2. Somewhat likely
3. Not likely
4. Unsure
5. Not applicable

IRS Audits

- A. Centralized risk-based audit approach
- B. Documentation (software companies typically do not have records in the form/format IRS desires; e.g., no lab notebooks, lots of white board discussions)
 - Percent of time spent on qualified services
 - Templates, standard procedures (make it easy for yourself and the IRS)
 - Software development lifecycle
 - Product development roadmap
 - Tasks, Story Points
 - “Commit” history
 - Bug reports
 - Release notes

IRS Audits (continued)

C. Significant economic risk test

- Technical uncertainties are often not documented or documentation is not retained by IT. In particular, technical uncertainties are often not documented prior to commitment of funds; rather, most uncertainties are understated in initial documents by developers because the documents are typically used to present to executives and obtain funding for their proposed software developments.
- There is almost always a reasonably high level of certainty that software can be developed as intended when large amounts of dollars are committed.

D. IT department commitment of resources/support

IRS Audits (continued)

- E. Third-Party vendor contracts and funded research
- F. ASC v. Regular Method selection (given audit experience – hedging your credits)
- G. Systems integrators – what do you do with work that is designed to get systems to work together?
- H. Effect of outside expert involvement
- I. How has the audit environment changed? Has making the credit “permanent” helped?
- J. Impact of COVID on audits

Polling Question #4

I have participated in an IRS exam for research credits claimed for software development and contemporaneous documentation was:

1. Requested, and the IRS found it persuasive
2. Requested, but the IRS did not find it persuasive or only partially persuasive
3. Requested, but the IRS did not comment on its evidentiary value
4. Never requested by the IRS
5. Not applicable

Documentation / Record-Keeping

- Treas. Reg. 1.41-4(d): Recordkeeping for the research credit. A taxpayer claiming a credit under section 41 must retain records in a sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.
- Claimants are not expected to implement exhaustive record-keeping processes.
- Timesheet systems are often *perceived* to be the preferred record-keeping system for R&D claims. But these may not always be the most appropriate method. The key is to implement an appropriate real-time approach to identifying R&D projects and costs – in whatever form best suits your business.
- Good record-keeping processes are important – but the extent and exact form of record-keeping will naturally be different for every business.
 - For example, a software company may already have a timesheet system in place for client projects – this can be used to record R&D activity.

Unhelpful Touchpoints

- *Eustace v. Comm’r*, T.C. Memo. 2001-66
 - “We note at the outset that petitioners’ reconstruction of qualifying percentages was unreliable, inaccurate, incomplete, and wholly insufficient to establish what various workers did and whether such expenses qualify for the research credit.”
- *Shami v. Comm’r*, T.C. Memo. 2012-78, aff’d, 741 F.3d 560 (5th Cir. 2014)
 - “The testimony of the two FS employees was general, vague, conclusory and insufficient to establish the time Mr. Shami or Mr. McCall spent performing any specific service. In sum, we found all of their testimony self-serving and unreliable.”
- *Siemer Milling Co. v. Comm’r*, T.C. Memo. 2019-37
 - “While Siemer states that it engaged in a process of experimentation, there is little in the record to support this assertion. Even the credit studies for the years in issue included very little evidence of Siemer’s asserted process of experimentation.”

Helpful Touchpoints

- Availability of statistical sampling to prove a voluminous claim
 - *Bayer Corp. v. U.S.*, 2:09-cv-351 (W.D. Penn.), Order filed Mar. 23, 2015
 - *CRA Holdings US, Inc. v. U.S.*, 15-CV-239W(F), 2017 WL 3404758 (W.D.N.Y. Aug. 9, 2017)
- Use of oral testimony and reasonable estimates to prove claim
 - *U.S. v. McFerrin*, 570 F.3d 672, 679 (5th Cir. 2009)
 - “But the court should look to testimony and other evidence, including the institutional knowledge of employees, in determining a fair estimate.”
 - *Union Carbide Corp. & Subs. v. Comm’r*, T.C. Memo. 2009-50, *110, *aff’d*, 697 F.3d 104 (2d Cir. 2012)
 - “Accordingly, under the reasoning of *Cohan v. Commissioner* ... 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.”
 - *Suder v. Comm’r*, T.C. Memo. 2014-201, *24
 - “On the basis of Mr. Wende’s credible testimony, the credible testimony of petitioner’s other witnesses, and the documentary evidence in the record, we find that Mr. Wende’s percentages were a reasonable estimate of the percentages of time ESI’s employees spent performing qualified services for 2004–07.”

Biography



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Caitlin is a director in Andersen’s national tax practice with a specific focus on federal and state R&D tax credit services. She has more than 10 years of experience providing R&D tax credit services to companies of various sizes. Prior to Andersen, she spent over a decade at Ernst & Young working within the quantitative services practice where she focused on substantiating and computing R&D tax credits and various other federal tax planning work. She also has experience defending R&D credit claims under IRS and state examination.

Her experience spans industries that include defense contracting, pharmaceutical, biomedical device, internal and external use software, architecture and engineering, manufacturing, retail, food and beverage, and automotive. Caitlin has a JD from Albany Law School and a BS in accounting from Villanova University.

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Brian P. Kaufman currently is a Vice President and Tax Counsel at Capital One Financial Corporation where he manages the Company's Federal, State, and International audits, administrative appeals, and litigation. He also leads a Tax Executives Institute/IRS Working Group on the R&D Tax Credit. Mr. Kaufman serves on the faculty as an Adjunct Professor in the Tax LLM Program at the Georgetown University Law Center. Prior to joining Capital One, Mr. Kaufman handled tax planning and tax controversy matters at Steptoe & Johnson LLP. He began his career as Trial Attorney in the Tax Division at the U.S. Department of Justice.

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Tom is a partner in the tax group of Morgan Lewis. He represents clients in complex tax controversies and tax litigation, and assists clients in determining the appropriate strategy in disputes with the IRS during audits, alternative dispute resolution proceedings, and trial and appellate litigation. Tom represents both US and non-US corporations, as well as individuals. He began his tax litigation career as a trial and appellate attorney in the Tax Division of the US Department of Justice.

Tom has nearly three decades of experience representing clients before the US Tax Court, federal district and bankruptcy courts, federal appeals courts, and the US Court of Federal Claims, and in briefing matters before the US Supreme Court. He earned his JD from Fordham University and his BS cum laude from Central Michigan University.

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Shawn Marchant is a tax principal at Tanner LLC. For more than 20 years he has been advising clients regarding federal and state tax credits and incentives, primarily in the area of research credits. His experience ranges from initial scoping through project implementation and delivery, project management, IRS and state audit support, and evaluation of benefits for financial statement presentation. Shawn spent 16 years in the Big Four, most recently with Ernst & Young in the Southeast region. He began his career in Deloitte's national R&D tax credit group and spent two years in its accounting methods and periods national practice group in Washington, DC.

A frequent speaker on the R&D credit, Shawn is an attorney licensed in California. He received a JD from BYU J. Reuben Clark Law School and an LLM (Tax) from Georgetown University Law School.

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QUIZ

Quiz Question 1

A taxpayer must file a Form 3115, Application for Change in Accounting Method, if it deducts a new type of cost as a research or experimental expenditure under section 174.

- A. True
- B. False

Quiz Question 2

In which case did the court allow the cost of paint as a supply QRE?

- A. Fairchild Industries
- B. Lockheed Martin
- C. Trinity Industries
- D. Shami

Quiz Question 3

When Michael Jordan played for the Chicago Bulls, how many NBA Championships did he win?

- A. Three
- B. Five
- C. Six

Quiz Question 4

The issuance of a patent by the Patent & Trademark Office is conclusive evidence that a taxpayer has engaged in qualified research.

- A. True
- B. False

Quiz Question 5

The following type of cost is allowable if the taxpayer is able to show its expenditures were extraordinary:

- A. Allocable overhead
- B. Patent prosecution and defense expenses
- C. Payments to research consortia
- D. Utilities

Quiz Question 6

How many hearts does an octopus have?

- A. Three
- B. Four
- C. Eight

Quiz Question 7

In what case did ML attorney Tom Linguanti, working for the Justice Department, persuade a district court that the taxpayer had failed to prove its base period?

- A. Norwest
- B. Research, Inc
- C. Lockheed Martin
- D. Eustace

Quiz Question 8

Which of the following research credit cases was *not* appealed?

- A. Fairchild Industries
- B. Geosyntec
- C. Union Carbide
- D. Norwest Corp.

Quiz Question 9

Which planet is the hottest in the solar system?

- A. Jupiter
- B. Uranus
- C. Venus
- D. Mercury

Quiz Question 10

Which country produces the most coffee in the world?

- A. Ethiopia
- B. Brazil
- C. Vietnam
- D. Colombia



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