

## LB&I Process Unit

<b>Unit Name</b>	Revised ASC 730 Directive - Computing Qualified Research Expenses	
<b>Primary UIL Code</b>	41.51-00	Qualified Research Expenses

<b>Library Level</b>	<b>Title</b>
<b>Knowledge Base</b>	Corporate/Business Issues & Credits
<b>Shelf</b>	General Business and Energy Credits
<b>Book</b>	Credit for Increasing Research Activities - IRC 41
<b>Chapter</b>	Administrative Procedures (Related to Research Credit)

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# Process Overview

## Revised ASC 730 Directive - Computing Qualified Research Expenses

Examining the credit for increasing research activities under IRC 41 (research credit) involves significant resources of both taxpayers and the Internal Revenue Service. Taxpayers following U.S. Generally Accepted Accounting Principles (GAAP) for book, use Accounting Standards Codification (ASC) Topic 730: Research and Development when disclosing research & development (R&D) costs on their financial statements. The definitions of R&D under ASC 730 and research and experimental under IRC 174 and IRC 41 have many similarities. These similarities coupled with the taxpayer's attestation that the costs reported as qualified research expenditures (QREs) are ASC 730 R&D costs, less specifically excluded costs (for example, general and administrative, foreign research, and quality control), may assist the Exam team (Exam) in significantly reducing the scope of the examination and the resources required for the taxpayer and the Service.

On September 10, 2020, the Commissioner of the Large Business & International Division (LB&I) issued a revised directive titled, "Guidance for Allowance of the Credit for Increasing Research Activities under IRC 41 for Taxpayers that Expense Research and Development Costs on Their Financial Statements Pursuant to ASC 730" (Revised Directive). This Revised Directive clarifies the same titled directive signed on September 11, 2017 (Original ASC 730 Directive). The purpose of the Revised Directive, like the Original ASC 730 Directive, is to provide an efficient manner for determining QREs. This Practice Unit (although similar to the Practice Unit titled "ASC 730 Directive - Computing Qualified Research Expenses") provides guidance regarding the Revised Directive.

The Revised Directive and this Process Unit only apply to LB&I taxpayers who follow GAAP to prepare their Certified Audited Financial Statements (CAFS). The CAFS must show the amount of the currently expensed Financial Statement R&D costs as a separate line item on the income statement or separately state such costs in a note to the CAFS. This Revised Directive only applies to taxpayers who use these same GAAP CAFS to reconcile book income to federal tax income on Schedule M-3.

In addition, the Revised Directive and this Process Unit only apply to LB&I taxpayers who choose to calculate their QREs using the requirements of the Revised Directive on original timely filed tax returns for tax periods ending on or after July 31, 2020. If the IRS determines that a taxpayer has satisfied all the requirements of the Revised Directive, then the Revised Directive provides an administrative solution for LB&I examiners to accept, as sufficient evidence of QREs, the Adjusted ASC 730 Financial Statement R&D for the Credit Year.

# Process Overview (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

Eligibility for the Revised Directive requires the taxpayer to fully complete and provide the following four disclosure statements included as appendices in the Revised Directive:

- Appendix A – Certification Statement Claiming Adjusted ASC 730 Financial Statement R&D as QREs,
- Appendix B – Reconciliation of Form 6765 QREs to Adjusted ASC 730 Financial Statement R&D (reconciliation should include a breakdown of costs as detailed in Appendix B),
- Appendix C – Computation of Adjusted ASC 730 Financial Statement R&D, and
- Appendix D – Adjusted ASC 730 Financial Statement R&D Wage Detail (calculating the wages and upper management wage limit).

In addition, LB&I taxpayers following the Revised Directive must properly retain and timely submit (following the LB&I Information Document Request (IDR) enforcement process) the documentation listed in Part V of the Revised Directive when requested by Exam.

# Detailed Explanation of the Process

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Analysis

This Process Unit explains the Revised Directive, and the five steps (Steps 1 – 5, which involve completing Appendices C & D) an LB&I taxpayer takes to adjust (for tax) the amount reported as ASC 730 R&D expenses on its CAFS in determining its QREs. These adjustments reconcile the differences between Financial Statement R&D expenditures and those allowed under IRC 174 and IRC 41.

Step 6 of this Process Unit explains how the taxpayer reconciles the QREs claimed on the Form 6765 - *Credit for Increasing Research Activities*. QREs in excess of the Adjusted ASC 730 Financial Statement R&D amount, that is, Appendix B, columns B and C, claimed on the Form 6765 are subject to an examination process which includes risk analysis, identification of the business component associated with the expenses, and determining whether the taxpayer satisfies the other requirements of IRC 41 and the underlying regulations.

This Process Unit also provides examples to clarify the intent of the Original ASC 730 Directive and the Revised Directive in determining Adjusted ASC 730 Financial Statement R&D amount.

Reviewing a printed copy of the Revised Directive, FAQs linked on the face of the Revised Directive and the Examples of the Process (covered later in this Process Unit) will assist to understand, complete, and review the required appendices.

Taxpayer must not adjust on any line of the Appendix C, any expense, cost or account not reported in Appendix C, line 1. For example, taxpayer may not use expenses excluded from the amount reported as R&D on its CAFS to adjust any line on the Appendix C to compute the Revised Directive QREs.

The taxpayer summarizes the QREs on Appendix B or a similar schedule before recording them on the Form 6765.

Examiners needing assistance with the audit of the Revised Directive should contact the General Business Credits Practice Network.

# Summary of Process Steps

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Process Steps

Steps 1 – 5 determine the Adjusted ASC 730 Financial Statement R&D QREs from the Revised Directive, Appendix C & D. Step 6, Appendix B, summarizes the Directive (Column A), non-Directive (Columns B & C) and Total (Column D) QREs.

<a href="#"><u>Step 1</u></a>	Subtractions From Financial Statement R&D, Non-Consolidated Tax Return R&D Amounts, Lines 1 – 1b
<a href="#"><u>Step 2</u></a>	Subtractions From U.S. Financial Statement R&D, Non ASC 730 Amounts, Lines 2 – 4
<a href="#"><u>Step 3</u></a>	Subtractions (Not Previously Adjusted in Steps 1 & 2 Above) From U.S. ASC 730 Financial Statement R&D, Lines 5 – 10
<a href="#"><u>Step 4</u></a>	U.S. ASC 730 Financial Statement R&D Employee Wage Adjustment, Lines 13 – 17

# Summary of Process Steps (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Process Steps

Steps 1 – 5 determine the Adjusted ASC 730 Financial Statement R&D QREs from the Revised Directive, Appendices C & D. Step 6, Appendix B, summarizes the Directive (Column A), non-Directive (Columns B & C) and Total (Column D) QREs.

<a href="#">Step 5</a>	Adjusted ASC 730 Financial Statement R&D, Lines 19 – 22
<a href="#">Step 6</a>	Summary of Costs – Appendix B



# Step 1: Subtract From Financial Statement R&D, Non-Consolidated Tax Return R&D Amounts Lines 1 – 1b

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Step 1

The starting point for determining the Adjusted ASC 730 Financial Statement R&D is the amount the taxpayer reported as Research and Development on its Certified Audited Financial Statements.

Considerations	Resources
<p>Taxpayers who do not have CAFS prepared on a GAAP basis are not eligible to follow the Revised Directive. The same GAAP financial statements must reconcile book income to federal tax income on Schedule M-3.</p> <p>The amount reported on Appendix C, line 1 of the Revised Directive Appendix C is the amount taxpayer reported as Financial Statement R&amp;D expenses on the CAFS. These are the costs the taxpayer reported separately as R&amp;D on its Income Statement in the CAFS or stated as the R&amp;D amount in the Notes to the CAFS. Again, these costs are also the same expenses specifically reported as R&amp;D on the Schedule M-3.</p> <p>Taxpayers may identify as R&amp;D on Appendix C, line 1 expenses reported on the CAFS using other terminology. For example, a taxpayer may use the term “Research, Development and Engineering,” “Product Development,” “Product Design,” or other similar terms to report development activities for their products. Although these activities may involve the development of a product, they may not qualify as R&amp;D under ASC 730. (See Exceptions below.)</p>	<ul style="list-style-type: none"> <li>▪ Revised LB&amp;I Directive - <i>Guidance for Allowance of the Credit for Increasing Research Activities under IRC 41 for Taxpayers that Expense Research and Development Costs on their Financial Statements pursuant to ASC 730, Appendix C - Computation of Adjusted ASC 730 Financial Statement R&amp;D (9/10/2020)</i></li> <li>▪ Form 10-K - <i>Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934</i></li> <li>▪ ASC 730 - <i>Research and Development</i></li> </ul>

# Step 1: Subtract From Financial Statement R&D, Non-Consolidated Tax Return R&D Amounts Lines 1 – 1b (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 1](#)

Considerations	Resources
<p>Compare the amount on Appendix C, line 1 to the R&amp;D expenses the taxpayer separately reported on the CAFS or the R&amp;D amount separately stated in the Notes to the CAFS. The taxpayer should explain any differences.</p> <p>Publicly traded companies also report their R&amp;D on the Form 10-K. This should be the same as the amount reported on the CAFS. The taxpayer should explain any differences.</p> <p>Verify the taxpayer used the GAAP accounting standard on Schedule M-3, Part I, line 4(b). If the box is not checked, the taxpayer is stating it did not use its GAAP CAFS as the starting point for preparing its return. Therefore, the taxpayer is ineligible to use the Revised Directive.</p> <p>Financial Statement R&amp;D on the CAFS might include R&amp;D expenditures from related foreign entities. The taxpayer must remove any R&amp;D amounts for foreign entities included in its Form 10-K or separately stated in its CAFS on Appendix C, line 1a of the Revised Directive.</p>	<ul style="list-style-type: none"> <li>▪ <i>FAQs - IRC 41 QREs and ASC 730 LB&amp;I Directive – Section – Certified Audited Financial Statements – Q2</i></li> <li>▪ <i>Form 1120, Schedule M-3 - Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More</i></li> <li>▪ <i>IRC 41(d)(4)(F)</i></li> </ul>

# Step 1: Subtract From Financial Statement R&D, Non-Consolidated Tax Return R&D Amounts Lines 1 – 1b (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 1](#)

Considerations	Resources
<p>Typically for book, the taxpayer accounts for R&amp;D activities performed by foreign entities separately from the U.S. entities' R&amp;D activities.</p> <p>Financial Statement R&amp;D on the CAFS might also include R&amp;D expenses from U.S. entities excluded from the taxpayer's consolidated federal income tax return. If an entity of a consolidated group included in the CAFS files a separate federal income tax return, taxpayer must remove that entity's R&amp;D amount on Appendix C, line 1b of the Revised Directive.</p> <p>Step 1 minus lines 1a and 1b equals U.S. Financial Statement R&amp;D.</p> <p>Generally, this is the U.S. book R&amp;D amount that the taxpayer specifically reported as R&amp;D on Schedule M-3, Part III Research and Development Costs in Column A. If the amount reported as R&amp;D on the M-3 does not agree to what was recorded as U.S. book R&amp;D, the taxpayer must explain any differences.</p>	

# Step 2: Subtract From U.S. Financial Statement R&D, Non ASC 730 Amounts, Lines 2 – 4

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Step 2


Taxpayer's R&D amount reported on the audited financial statement may include costs other than ASC 730 R&D expenses. This step removes all non ASC 730 R&D costs.

Considerations	Resources
<p>Financial Statement R&amp;D on CAFS sometimes includes a portion of taxpayer's costs for the development of internal-use software (ASC 350-40, GAAP Internal Use Software), web development activities, (ASC 350-50 GAAP Web Development costs), or a combination of both. Although the costs for these activities may qualify under IRC 41 (assuming statutory and regulatory requirements are satisfied), they do not fall within the scope of ASC 730. Appendix C, line 3a of the Revised Directive removes costs for software development activities not for sale, lease or otherwise marketed.</p> <p>The IRS developed FAQs for the Revised Directive that includes discussion of software development activities. Taxpayers and Exam should review the FAQs to understand the IRS's position on software not for sale, lease or otherwise marketed for the Revised Directive.</p> <p>Within Step 2 of Appendix C, line 3b, a taxpayer must adjust costs for activities identified in ASC 730-10-55-2 as well as other non-ASC 730 costs reported on the financial statements as R&amp;D and included on Appendix C, line 1. These costs and their associated activities may relate to product development or design but do not fall within the scope of ASC 730. Therefore, exclude these costs from the computation.</p>	<ul style="list-style-type: none"> <li>▪ <i>FAQs - IRC 41 QREs and ASC 730 LB&amp;I Directive</i></li> </ul>

# Step 2: Subtract From U.S. Financial Statement R&D, Non ASC 730 Amounts, Lines 2 – 4 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 2](#)

Considerations	Resources
<p>ASC 730-10-55-2 provides examples of activities typically excluded from R&amp;D under ASC 730. Taxpayers must report on line 3b costs associated with these activities that were reported as R&amp;D on their CAFS, that is, the amount reported on Appendix C, line 1.</p> <p>ASC 730-10-15-4 also provides some examples of transactions and activities not included in ASC 730. These examples are not a comprehensive list of all non-ASC 730 costs.</p> <p> <b>CAUTION:</b> Taxpayers should conduct a thorough review of the costs and activities reported on Appendix C, line 1 to identify and adjust any not allowed as ASC 730 expenses. Taxpayers adjust these costs on Appendix C, lines 3a and 3b.</p> <p>Removal of expenses from Appendix C does not prevent the taxpayer from claiming these costs as additional QREs outside of the Revised Directive, that is, outside of what the taxpayer reported on Appendix B, Column A. Taxpayers may claim costs removed in Step 2 that meet the requirements of IRC 174, IRC 41 and the underlying regulations on Appendix B, Column C. The QREs are subject to an examination process which includes risk analysis, identification of the business component associated with the expenses and determining whether the taxpayer satisfies the other requirements of IRC 41 and the underlying regulations.</p>	

# Step 2: Subtract From U.S. Financial Statement R&D, Non ASC 730 Amounts, Lines 2 – 4 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 2](#)

Considerations	Resources
<p>Note: A taxpayer must not include as allowable W-2 wages in Step 4, lines 15, 16 &amp; 17 any book or stock option wages subtracted in Step 2.</p> <p>Step 1 minus Step 2 equals U.S. ASC 730 Financial Statement R&amp;D.</p>	

# Step 3: Subtractions From ASC 730, Lines 5 - 10

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Step 3

This multi-step process (lines 5 through 10 of Appendix C of the Revised Directive) removes costs not meeting the requirements of IRC 174 and 41 plus additional excluded costs from the U.S. ASC 730 Financial Statement R&D amount.

Considerations	Resources
Appendix C, Step 3 of the Revised Directive includes lines 5 – 10. This multi-step process removes from U.S. ASC 730 Financial Statement R&D those costs for activities not allowed under IRC 174 and 41 and other costs specifically excluded in determining the Adjusted ASC 730 Financial Statement R&D expenses. See each line instruction in Step 3 for specific considerations.	<ul style="list-style-type: none"><li>▪ IRC 41</li><li>▪ IRC 174</li></ul>

# Step 3: Subtractions From ASC 730, Lines 5 - 10 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 3](#)

Considerations	Resources
<p><u>Appendix C, Step 3, Line 5 - Subtract All U.S. ASC 730 Financial Statement R&amp;D General Ledger (GL) Accounts or Items Specifically Excluded from IRC 174</u></p> <p>The taxpayer should subtract expenses included in their U.S. ASC 730 Financial Statement R&amp;D amount (Appendix C, line 4) not allowed under IRC 174 or any other costs not meeting IRC 174. Costs not allowed by regulation include the following:</p> <ul style="list-style-type: none"> <li>▪ Quality control testing,</li> <li>▪ Efficiency surveys,</li> <li>▪ Management studies,</li> <li>▪ Consumer surveys,</li> <li>▪ Advertising of promotions,</li> <li>▪ Acquisition of another's patent, model, production or process,</li> <li>▪ Research in connection with literary, historical, or similar projects,</li> <li>▪ Research expenditures in excess of reasonable amounts, or</li> <li>▪ Expenditures for the acquisition or improvement of land or depreciable property which the taxpayer purchases.</li> </ul> <p>The taxpayer reports the ASC 730 costs not meeting the requirements of IRC 174 but included in Financial Statement R&amp;D, (the list above is not exclusive) as adjustments on its Schedule M-3, Part III, Research and Development Costs, columns B and C.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.174-2(a)(6)-(10)</li> </ul>



# Step 3: Subtractions From ASC 730, Lines 5 - 10 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 3](#)

Considerations	Resources
<p><u>Appendix C, Step 3, Line 6 - Subtract All U.S. ASC 730 Financial Statement R&amp;D GL Accounts and Expenditures and All Other Items Not Eligible for IRC 41 QREs</u></p> <p>This is not an exclusive list. The taxpayer subtracts expenses recorded in the ASC 730 Financial Statement R&amp;D that are not allowed as QREs under IRC 41. These costs may include the following:</p> <ul style="list-style-type: none"> <li>▪ Depreciation,</li> <li>▪ Amortization,</li> <li>▪ Shipping,</li> <li>▪ Training,</li> <li>▪ Travel,</li> <li>▪ General and administrative expenses,</li> <li>▪ Overhead,</li> <li>▪ Rent,</li> <li>▪ All other items/expenses not eligible for IRC 41 QRE's, or</li> <li>▪ Any combination of the above.</li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 41(b)</li> <li>▪ Treas. Reg. 1.41-2</li> </ul>

# Step 3: Subtractions From ASC 730, Lines 5 - 10 (cont'd)

**Revised ASC 730 Directive - Computing Qualified Research Expenses**

[Step 3](#)

Considerations	Resources
<p><u>Appendix C, Step 3, Line 7 - Subtract All U.S. ASC 730 Financial Statement Costs Incurred for All Agreements/Contracts Where the Taxpayer Performed ASC 730 Research in Order to Comply with the Terms of the Agreements/Contracts</u></p> <p>The taxpayer should remove costs incurred for research activities it conducted on behalf of third parties from the Adjusted ASC 730 R&amp;D expenses.</p> <p>The taxpayer should subtract these costs regardless of whether it incurred them in connection with funded research.</p> <p>Typically, these expenses consist of wages and supplies, but can include contract labor.</p> <p>Removal of expenses here does not prevent the taxpayer from claiming these costs as additional QREs outside of the Revised Directive, (See Appendix B, Columns B and C.) Additional QREs are subject to an examination process which includes risk analysis, identification of the business component associated with the expenses and determining whether the taxpayer satisfies the other requirements of IRC 41 and the underlying regulations.</p>	<ul style="list-style-type: none"> <li>▪ IRC 41(d)(4)(H)</li> </ul>

# Step 3: Subtractions From ASC 730, Lines 5 - 10 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses



### [Step 3](#)

Considerations	Resources
<p><u>Appendix C, Step 3, Line 8 - Subtract All U.S. ASC 730 Financial Statement R&amp;D Costs Incurred for All Persons Other Than Taxpayer's Employees) Who Performed ASC 730 Research on Behalf of the Taxpayer</u></p> <p>Although the taxpayer is typically allowed 65% of qualifying research expenditures for third-party subcontractor costs in calculating the research credit, the Revised Directive removes the full amount of these costs from the Adjusted ASC 730 Financial Statement R&amp;D expenses.</p> <p>Removal of the expenses here does not prevent the taxpayer from claiming these costs as additional QREs outside of the Revised Directive. See Appendix B, Columns B or C. Additional QREs are subject to an examination process which includes risk analysis, identification of the business component associated with the expenses and determining whether the taxpayer satisfies the other requirements of IRC 41 and the underlying regulations.</p>	<ul style="list-style-type: none"> <li>▪ IRC 41(b)(3)</li> <li>▪ Treas. Reg 1.41-(2)(e)</li> <li>▪ IRC 41(d)(4)(H)</li> </ul>

# Step 3: Subtractions From ASC 730, Lines 5 - 10 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 3](#)

Considerations	Resources
<p><u>Appendix C, Step 3, Line 9 - Subtract All U.S. ASC 730 Financial Statement R&amp;D In-house Research Performed Outside the U.S.</u></p> <p>The taxpayer should subtract all the wages and wage-related costs (including stock options if included in the U.S. ASC 730 R&amp;D Financial Statement, Appendix C, line 4) it incurred or paid to individuals for ASC 730 research performed outside the U.S.</p> <p> <b>CAUTION:</b> The taxpayer should also subtract costs for any supplies used in research performed outside of the U.S.</p> <p> <b>CAUTION:</b> Do not include these wages in Appendix C, Step 4 on lines 13 &amp; 14.</p> <p>Do not include the W-2 wages related to the book wages and stock options subtracted here in calculating the allowable wages in Step 4, lines 15, 16 &amp; 17.</p>	<ul style="list-style-type: none"> <li>▪ IRC 41(d)(4)(F)</li> <li>▪ Treas. Reg 1.41-4(c)(7)</li> </ul>

# Step 3: Subtractions From ASC 730, Lines 5 - 10 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 3](#)

Considerations	Resources
<p><u>Appendix C, Step 3, Line 10 - Subtract All Prototype Overhead, Patent Costs, and Severance Pay Included in U.S. ASC 730 Financial Statement R&amp;D</u></p> <p>The definition of QREs eligible for the research credit under IRC 41(b)(1) is significantly narrower than the definition of research or experimental (R&amp;E) expenditures qualifying for a trade or business deduction under IRC 174. For example, IRC 174 costs include the costs of obtaining a patent, such as attorneys' fees expended in making or perfecting a patent application, but attorneys' fees and other general and administrative costs (including regulatory and registration administrative costs) generally do not qualify as QREs.</p> <p>Typically, severance payments fail to qualify as QREs and are therefore outside the scope of the Revised Directive. These payments typically represent costs the taxpayer agreed to pay to specific individuals because they are leaving the company and are not compensation for research or experimental activities as required by IRC 174(a).</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.174-2(a)(1)</li> <li>▪ IRC 41(d)</li> <li>▪ IRC 174(a)</li> <li>▪ FAA 20131102F – Treatment of Voluntary Separation Payments as Qualified Research Expenditures Under IRC 41</li> </ul>

# Step 4: R&D Wage Adjustments, Lines 13 – 17

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Step 4

This is a multi-step process to subtract all U.S. ASC 730 Financial Statement R&D Book Wage and Wage Related Accounts not previously subtracted and replace it with the W-2 wage and stock option amount calculated in Appendix D.

Considerations	Resources
Appendix C, Step 4, lines 13 – 14 of the Revised Directive removes all remaining U.S. ASC 730 Financial Statement R&D wages and stock options before adding back the W-2 Wages on lines 15 - 17. The taxpayer should not include any W-2 compensation amounts relating to the subtractions in Steps 1, 2 and 3. For example, if the taxpayer removed wages on line 5 for activities completed by employees that fail to meet IRC 174, then taxpayer should remove the W-2 equivalent wages for the same activities.	

# Step 4: R&D Wage Adjustments, Lines 13 – 17 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 4](#)

Considerations	Resources
<p><u>Appendix C, Step 4, Line 13 – Subtract U.S. ASC 730 Financial Statement R&amp;D Wage and Wage Related Accounts Not Already Subtracted in the Lines Above</u></p> <p>Book wages are typically not an accurate reflection of an employee's gross W-2 income and the Revised Directive removes them from the computation. The taxpayer must subtract any book wages remaining in the U.S. ASC 730 Financial Statement R&amp;D amount (Appendix C, line 11a.) not previously subtracted. This results in no book wages remaining in the computation. The taxpayer then adds back W-2 wages included in the Revised Directive in Step 4, lines 15 – 17 later. These wages do not include the W-2 wages for any book wages previously removed in Steps 1, 2 or 3.</p> <p>The only wages allowed as QREs are generally wages identified under IRC 3401(a), which include any amount reported in the employee's gross W-2 income which are not used in calculating other credits such as the Work Opportunity Credit or the Employee Retention credit claimed under IRC 38.</p>	

# Step 4: R&D Wage Adjustments, Lines 13 – 17 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 4](#)

Considerations	Resources
<p><u>Appendix C, Step 4, Line 14 – Subtract U.S. ASC 730 Financial Statement R&amp;D Stock-Based Compensation Not Already Subtracted in the Lines Above</u></p> <p>This step removes book stock options the taxpayer included in Appendix C, line 2, U.S. ASC 730 Financial Statement R&amp;D.</p> <p>Taxpayers do not always report stock options in ASC 730 accounts. If a taxpayer reports employees' stock-based compensation as R&amp;D and did not previously subtract it in Step 3, the taxpayer must subtract the amount of stock-based compensation included in U.S. ASC 730 Financial Statement R&amp;D (Appendix C, line 2).</p> <p>The taxpayer only adds back allowed taxable W-2 stock compensation for qualified individual contributors (QIC) and first level supervisor managers (both defined in the "Definitions" section of this Practice Unit) in Step 4, lines 15 – 16 later.</p>	



# Step 4: R&D Wage Adjustments, Lines 13 – 17 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 4](#)

Considerations	Resources
<p><u>Appendix C, Step 4, Line 15 – Add 95% of the W-2 Wages for Qualified Individual Contributors</u></p> <p>The W-2 wages for the QICs include both wages and stock options. See the “Definitions” section of this Practice Unit for the definition of a qualified individual contributor.</p> <p>Following the steps of Appendix D of the Revised Directive, the taxpayer adds back 95% of the taxable wages for QICs:</p> <ul style="list-style-type: none"> <li>▪ Whose wages it did not previously exclude for internal-use software and web development activities, non ASC 730 services, contract work, work abroad, that is, adjustments in Steps 1-3),</li> <li>▪ Who do not manage any other taxpayer employees,</li> <li>▪ Whose wages the taxpayer charged to U.S. ASC 730 Financial Statement Cost Centers, and</li> <li>▪ Whose book wages remain in the amount included on Appendix C, line 11a.</li> </ul> <p>The taxpayer should separately identify the amounts reported for base W-2 wages from the W-2 stock options on Appendix D, lines 1- 3. Base wages are wages as defined by IRC 3401(a) not including taxable stock options included in the W-2 Box 1 wages.</p>	<ul style="list-style-type: none"> <li>▪ Revised LB&amp;I Directive - <i>Guidance for Allowance of the Credit for Increasing Research Activities under IRC 41 for Taxpayers that Expense Research and Development Costs on their Financial Statements pursuant to ASC 730, Appendix D Adjusted ASC 730 Financial Statement R&amp;D Wage Detail (9/10/2020)</i></li> <li>▪ IRC 3401(a)</li> </ul>

# Step 4: R&D Wage Adjustments, Lines 13 – 17 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 4](#)

Considerations	Resources
<p><u>Appendix C, Step 4, Line 16 - Add 95% of W-2 Wages for 1st Level Supervisor Managers</u></p> <p>The W-2 wages for 1st Level Supervisors include both wages and stock options. From Appendix D of the Revised Directive, the taxpayer adds back 95% of the taxable wages for 1st level supervisor managers:</p> <ul style="list-style-type: none"><li>▪ Whose wages it did not previously exclude for internal-use software and web development activities, non ASC 730 services, contract work, work abroad, (that is, adjustments in Steps 1-3),</li><li>▪ Who only manage QICs,</li><li>▪ Whose wages the taxpayer charged to U.S. ASC 730 Financial Statement Cost Centers and</li><li>▪ Whose book wages remain in the amount included on Appendix C, line 4.</li></ul> <p>The taxpayer should separately identify the amounts reported as base W-2 wages from the W-2 stock options on Appendix D, lines 4 – 6.</p>	

# Step 4: R&D Wage Adjustments, Lines 13 – 17 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 4](#)

Considerations	Resources
<p><u>Appendix C, Step 4, Line 17 – Add Upper Level Managers' Limit</u></p> <p>For this Process Unit and the Revised Directive, an “Upper Level Manager” (ULM) is a manager that directly supervises any employee other than a QIC and whose wages the taxpayer charged to U.S. ASC 730 Financial Statement cost centers and whose book wages remain in the amount included on Appendix C, line 11a.</p> <p>These individuals may or may not provide direct supervision or direct support to QICs. Qualifying research expenses include wages the taxpayer paid for qualifying services. Qualified services include wages the taxpayer paid or incurred for employees engaging in qualified research, direct supervision of qualified research, or direct support of qualified research activities.</p> <p>Limit the ULM's wages to the lesser of:</p> <ul style="list-style-type: none"> <li>▪ 10% of the sum of the total W-2 wages for QIC and the total W-2 wages for 1st level supervisor managers calculated for Appendix D of the Revised Directive, lines 3 and 6, that is, 95% of the total of these individuals' W-2 wages, OR</li> <li>▪ 100% of the total W-2 wages and stock options of the ULM.</li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 41(b)</li> </ul>

# Step 4: R&D Wage Adjustments, Lines 13 – 17 (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 4](#)

Considerations	Resources
<p><u>Appendix C, Step 4, Line 17 – Add Upper Level Managers' Limit (cont'd)</u></p> <p>The taxpayer reports the limited amount as calculated on the previous slide, on Appendix D, line 7 and Appendix C, line 17.</p> <p>If a taxpayer wants to report more than the limitation allowed for the ULM, the taxpayer is not eligible to include any of the ULM wages in the Adjusted ASC 730 Financial Statement R&amp;D amount. In this case, the taxpayer reports \$0 on Appendix C line 17.</p> <p>If taxpayer elects to claim more than the limited amount as QREs, the taxpayer reports the amount they determine eligible on Appendix B, Columns B and C. This amount is subject to an examination process which includes risk analysis, identification of the business component associated with the expenses, and determining whether the taxpayer satisfies the other requirements of IRC 41 and the underlying regulations.</p>	

# Step 5: ASC 730 QREs, Lines 19 – 22

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Step 5

This is a multi-step process to subtract all U.S. ASC 730 Financial Statement R&D Book Wage and Wage Related Accounts not previously subtracted and replace it with the W-2 wage and stock option amount calculated in Appendix D.

Considerations	Resources
<p><u>Appendix C, Step 5, Line 19 - Equals the Adjusted ASC 730 Financial Statement R&amp;D</u></p> <p>The taxpayer determines this amount by adding Appendix C, line 11a (US ASC 730 Financial Statement R&amp;D minus all Step 3 adjustments) of the Revised Directive to Appendix C, line 18 (the net of Step 4 adjustments).</p> <p><u>Appendix C, Step 5, Lines 20 – 22 Identify the Cost on Line 19 to the Specific Cost Category</u></p> <p>From the amount reported as the Adjusted ASC 730 Financial Statement R&amp;D on Appendix C, line 19, identify the amount of:</p> <ul style="list-style-type: none"> <li>▪ Line 20 Wages – Report on Appendix B, Column A, Form 6765, line 5 or 24, Wages for Qualified Services.</li> <li>▪ Line 21 Cost of Supplies – Report on Appendix B, Column A, Form 6765, line 6 or 25, Cost of Supplies.</li> <li>▪ Line 22 Rental or Lease Costs of Computers – Report on Appendix B, Column A, Form 6765, line 7 or 26, Rental or Lease Costs of Computers.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Revised LB&amp;I Directive - <i>Guidance for Allowance of the Credit for Increasing Research Activities under IRC 41 for Taxpayers that Expense Research and Development Costs on their Financial Statements pursuant to ASC 730, Appendix B, Reconciliation of Form 6765 QREs to Adjusted ASC 730 Financial Statement R&amp;D</i> (9/10/2020)</li> </ul>

## Step 5: ASC 730 QREs, Lines 19 – 22 (cont'd)

### Revised ASC 730 Directive - Computing Qualified Research Expenses

#### [Step 5](#)

Considerations	Resources
The Revised Directive excludes costs associated with contracts performed by the taxpayer or on behalf of the taxpayer and does not include them in Appendix B, Column A (that is, the Adjusted ASC 730 Financial Statement R&D amount).	

# Step 6: Summary of Costs – Appendix B

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Step 6

This Step identifies where the taxpayer reports Steps 1 – 5 on the Appendix B.

Considerations	Resources
<p>Taxpayer follows Step 5 to report the Adjusted ASC 730 Financial Statement R&amp;D QRE Amounts on the appropriate lines of the Appendix B, Column A.</p> <p>On Appendix B, Column B, taxpayer only reports those ASC 730 amounts removed from the Appendix C meeting the requirements under IRC 41 and the underlying regulations.</p> <p>Taxpayer may report qualifying ASC 730 taxable W-2 wages paid to employees on Appendix B, Column B, Form 6765, line 5 or 24. These wages come from:</p> <ul style="list-style-type: none"> <li>▪ The amounts removed on Appendix C, line 7, wages paid pursuant to contracts,</li> <li>▪ The amount of qualifying ULM wages. (This amount is included only if the taxpayer chose to forego the 10% ULM wages on Appendix C, line 17), or</li> <li>▪ A combination of both.</li> </ul> <p>Taxpayer can only include the ASC 730 W-2 wages the taxpayer paid for qualified services performed in the U.S.</p>	<ul style="list-style-type: none"> <li>▪ Revised LB&amp;I Directive, <i>Guidance for Allowance of the Credit for Increasing Research Activities under IRC 41 for Taxpayers that Expense Research and Development Costs on their Financial Statements pursuant to ASC 730, Appendix B, Reconciliation of Form 6765 QREs to Adjusted ASC 730 Financial Statement R&amp;D</i> (9/10/2020)</li> </ul>

# Step 6: Summary of Costs – Appendix B (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### [Step 6](#)

Considerations	Resources
<p>On Appendix B, Column B, Form 6765, line 6 or 25, taxpayer can enter the amount of supply QREs paid or incurred in the performance of qualified research services to meet the terms of agreements or contracts with third parties.</p> <p>On Appendix B, Column B, Form 6765, line 8 or 27, taxpayer can enter the amount of contract research expenses paid or incurred in the performance of qualified research services to meet the terms of agreements/contracts with other third parties.</p> <p>On Appendix B, Column C, taxpayer reports the amount of expenses reported outside of ASC 730 R&amp;D that meet the requirements under IRC 41 and the underlying regulations.</p>	



# Definitions

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

- 1st Level Supervisor Managers - Managers that directly manage only Qualified Individual Contributors and whose wages are charged to U.S. ASC 730 Financial Statement Cost Centers.
- Adjusted ASC 730 Financial Statement R&D - Financial Statement R&D adjusted pursuant to the methodology shown in Appendix C of the Revised Directive and the definitions contained in Appendix E.
- ASC 730 - The Financial Accounting Standards Board (FASB) Accounting Standards Codification (“ASC”) is the source of authoritative GAAP the FASB recognizes for application to nongovernmental entities. ASC 730 establishes standards of financial accounting and reporting for research and development costs. It specifies:
  - Those activities that shall be identified as research and development for financial accounting and reporting purposes,
  - The elements of costs that shall be identified with research and development activities,
  - The accounting for research and development costs, and
  - The financial statement disclosures related to research and development costs.
- Base W-2 Wages - “Wages” as defined by section 3401(a) not including taxable stock compensation included in the W-2 Box 1 wages.

# Definitions (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

- Certified Audited Financial Statement - A financial statement that is accompanied by the report of an independent (as defined in the American Institute of Certified Public Accountants Professional Standards, Code of Professional Conduct, Rule 101 and its interpretations and rulings) Certified Public Accountant. A financial statement is “certified audited” for purposes of this Directive if it is:
  - Certified to be fairly presented (an unqualified or “clean” opinion),
  - Subject to a qualified opinion that such financial statement is fairly presented subject to a concern about a contingency (a qualified “subject to” opinion) other than a concern relating to ASC 730 reporting,
  - Subject to a qualified opinion that such financial statement is fairly presented, except for a method of accounting with which the accountant disagrees (a qualified “except for” opinion) where such disagreement does not relate to ASC 730, or
  - Subject to an adverse opinion not relating to ASC 730, but only if the accountant discloses the amount of the disagreement with the statement.

Any other statement or report, such as a review statement or a compilation report that is not subject to a full audit is not a certified audited statement.

- Chart of Accounts - A listing of the names of the accounts that a company has identified and made available for recording transactions in its general ledger.
- Contract Research - Any expense paid or incurred in carrying on a trade or business to any person other than an employee of the taxpayer for the performance on behalf of the taxpayer of: (i) Qualified research as defined in section 1.41-4 or 1.41-4A, whichever is applicable, or (ii) Services which, if performed by employees of the taxpayer, would constitute qualified services within the meaning of section 41(b)(2)(B).

# Definitions (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

- Credit Year - The taxable year for which the Research Credit is being determined.
- Financial Statement - Reports prepared by a company's management to present the financial performance and position at a point in time that are prepared in accordance with U.S. GAAP; that is given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investment in the taxpayer, or provided for other substantial non-tax purposes; and that the taxpayer reasonably anticipates will be directly relied on for the purposes for which it was given or provided.
- Financial Statement R&D - Research and development costs currently expensed for U.S. GAAP purposes and shown as a line item on a taxpayer's Certified Audited Financial Statements' income statement or separately expressed in a note to its Certified Audited Financial Statements.
- Foreign Entity - Any entity which is not a U.S. person.
- Funded Research - Research to the extent it is funded by any grant, contract, or otherwise by another person (including any governmental entity) where amounts payable to the taxpayer are not contingent upon the success of the research or the taxpayer does not retain a substantial right in the research. See section 1.41-4A(d).
- GL Accounts - The master set of general ledger accounts that summarize all transactions occurring within an entity. The general ledger is comprised of all the individual accounts needed to record the assets, liabilities, equity, revenue, expense, gain, and loss transactions of a business.
- Person - Shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.

# Definitions (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

- Prototype or Pilot Model - 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 includes a fully-functional representation or model of the product or a component of the product. See section 1.174-2(a)(4).
- Prototype Overhead - All costs other than direct labor and direct materials allocated to a Prototype.
- Qualified Individual Contributors - Employees of the taxpayer who do not manage any of the taxpayer's employees and whose wages are charged to U.S. ASC 730 Financial Statement Cost Centers.
- Quality Control Testing - Testing or inspection to determine whether particular units of materials or products conform to specified parameters. However, Quality Control Testing does not include testing to determine if the design of the product is appropriate. See section 1.174-2(a)(7).
- R&D GL Accounts - The GL Accounts which make up Financial Statement R&D.
- Rental and Lease Costs of Computers - The amount paid or incurred to another person for the right to use (time-sharing) computers in the conduct of qualified research. The computer must be owned and operated by someone other than the taxpayer, located off the taxpayer's premises, and the taxpayer must not be the primary user of the computer. See Treas. Reg. 1.41-2(b)(4).
- Supplies - Any tangible property other than: (i) land or improvements to land; and (ii) property of a character subject to the allowance for depreciation. See section 1.41-2(b)(1) & (2).
- Taxpayer - Person/entity choosing to follow this Revised Directive.

# Definitions (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

- Upper Level Managers - Managers that directly supervise any employee other than Qualified Individual Contributors and whose wages are charged to U.S. ASC 730 Financial Statement Cost Centers. For example, a manager that directly supervises a 1st Level Supervisor Manager and another Upper Level Manager is an Upper Level Manager. Also, a manager that supervises another manager and directly supervises Qualified Individual Contributors is an Upper Level Manager.
- U.S. - The United States, the Commonwealth of Puerto Rico, or any possession of the United States.
- U.S. ASC 730 Financial Statement Cost Centers - Organizational units (for example, business units, departments, cost centers) where the costs paid or incurred by those units are charged to U.S. ASC 730 Financial Statement R&D GL Accounts.
- U.S. ASC 730 Financial Statement R&D - U.S. Financial Statement R&D adjusted by removal of all expenses for software development paid or incurred in the development of software not for sale, lease, or otherwise marketed and for expenses incurred in activities listed in ASC 730-10-55-2 and other non-ASC 730 expenses.
- U.S. ASC 730 Financial Statement R&D GL Accounts - GL Accounts which make up U.S. ASC 730 Financial Statement R&D.
- U.S. ASC 730 Financial Statement R&D In-House Research - U.S. ASC 730 Financial Statement R&D adjusted by removal of Contract Research.
- U.S. ASC 730 Financial Statement R&D Stock Based Compensation - U.S. GAAP stock based compensation included in U.S. ASC 730 Financial Statement R&D.
- U.S. ASC 730 Financial Statement R&D Wage and Wage Related Accounts - U.S. GAAP Wage and Wage related accounts included in U.S. ASC 730 Financial Statement R&D and that are not U.S. ASC 730 Financial Statement R&D Stock Based Compensation.

# Definitions (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

- U.S. Financial Statement R&D - Financial Statement R&D adjusted by removal of all R&D GL Accounts relating to Foreign Entities.
- U.S. Financial Statement R&D GL Accounts - GL Accounts which makes up U.S. Financial Statement R&D.
- U.S. GAAP - United States Generally Accepted Accounting Principles, which are updated regularly to reflect the latest accounting methodologies, are the definitive source of accounting guidelines that companies rely on when preparing their financial statements. The standards are established and administered by the American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB).
- Wage - Compensation paid by the taxpayer to an employee of the taxpayer for services rendered by the employee to the taxpayer.
- W-2 Wages - "Wages" as defined by section 3401(a).

# Examples of the Process

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

Following are scenarios detailing how taxpayers should report their R&D expenses on the Revised Directive.

#### Examples 1a and 1b

Example 1a:

- Taxpayer 1 – Taxpayer is a privately held company. Taxpayer reported \$2B as R&D expenses on the CAFS for the tax year ending December 31, 2020. Taxpayer primarily develops software for sale, lease, or otherwise marketed following ASCs 985 & 730. However, taxpayer has a division that develops software only available via the Cloud. Taxpayer used the Revised Directive to compute its QREs. On Appendix C, line 1, taxpayer reports \$2B. Taxpayer has 10 subsidiaries, three of which are foreign entities whose R&D costs on the CAFS total \$200M. All U.S. subsidiaries file a consolidated tax return with the taxpayer.
- Taxpayer reports that of the \$1.8B on Appendix C, line 2, \$400M of the R&D expenses were incurred for the Cloud software development activities. In addition, taxpayer identified that of the remaining \$1.4B, \$300M is for engineering services performed during the early phases of commercial production and involved routine, ongoing efforts to improve an existing product. Based on the above information, taxpayer completes the top section of the Appendix C by reporting \$400M on line 3a and \$300M on line 3b. Taxpayer's U.S. ASC 730 Financial Statement R&D on line 4 is \$1.1B. (See example directly below). Taxpayer must further adjust these costs for non IRC 174, non IRC 41 expenditures and other adjustments required by the 2020 Revised Directive on lines 5-10.

Example 1b:

- Same facts as above. However, one of the taxpayer's subsidiaries has \$250M in non-software related ASC 730 R&D expenses included on the CAFS. This subsidiary does not file a consolidated federal income tax return with the taxpayer. Based on this information, taxpayer would report \$250M on line 1b and the net amount reported as U.S. ASC 730 Financial Statement R&D is \$850M. Taxpayer must exclude the amount of R&D reported on Appendix C, line 1 for any entity that does not file a consolidated federal income return with the taxpayer.

# Examples of the Process (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

Examples 1a and 1b (cont'd)

Line #	Line Description	Example 1a Amount	Example 1b Amount
<b>1</b>	<b>Financial Statement R&amp;D</b>	\$2,000,000,000	\$2,000,000,000
1a	Subtract: All amounts related to foreign entities.	\$ 200,000,000	\$ 200,000,000
1b	Subtract: All amounts related to U.S. entities that are not included in taxpayer's consolidated federal income tax return.	\$ 0	\$ 250,000,000
<b>2</b>	<b>U.S. Financial Statement R&amp;D (Line 1 minus Line 1a and 1b)</b>	\$1,800,000,000	\$1,550,000,000
2a	The Schedule M-3 amount (see instructions for Line 2a).	\$1,800,000,000	\$1,550,000,000
<b>3</b>	<b>Adjustments to U.S. Financial Statement R&amp;D Step 2</b>		
3a	Subtract: Expenses for Software not for sale, lease, or otherwise marketed	\$ 400,000,000	\$ 400,000,000
3b	Subtract: Expenses identified under ASC 730-10-55-2 or other <u>Non ASC 730</u> Expenditures.	\$ 300,000,000	\$ 300,000,000
<b>4</b>	<b>U.S. ASC 730 Financial Statement R&amp;D (Line 2 minus Line 3a and Line 3b)</b>	<b>\$1,100,000,000</b>	<b>\$ 850,000,000</b>



# Examples of the Process (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

#### Example 2

Taxpayer is a publicly traded company and files Form 10-K. The taxpayer does not have a separate line item on the Income Statement for R&D nor does the taxpayer quantify R&D elsewhere in the Form 10-K. However, in the Form 10-K the taxpayer explained its product development and design activities under the subtopic of R&D. Within the Notes to the CAFS, taxpayer addressed R&D but instead of quantifying the R&D amount, the Notes state taxpayer incurred \$800M in product development and design costs for the tax year ending December 31, 2020. Taxpayer uses the Revised Directive to compute its QREs. Taxpayer does not have any foreign partners nor any financial statement entities not filing a consolidated federal income tax return with the taxpayer. Taxpayer reports on Appendix C, line 1, \$800M. Taxpayer makes no adjustments on lines 1a – 3b and reports \$800M on Appendix C, line 4, that is, U.S. ASC 730 Financial Statement R&D.

Exam asks taxpayer to provide a verbal presentation of the product development process. Taxpayer explains the process including concept, development, testing, production, marketing and sale of the product. Exam requests taxpayer isolate the portion of activities and expenses related to the R&D activities within the scope of ASC 730. Based on taxpayer's bookkeeping system, they are unable to isolate the ASC 730 R&D activities and, therefore, taxpayer is not eligible to use the Revised Directive to determine its QREs. However, if the taxpayer can isolate their ASC 730 R&D activities and expenses to Exam's satisfaction and meet all other requirements for the Revised Directive, taxpayer may use the Revised Directive to determine its QREs.

# Examples of the Process (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

#### Example 3

Taxpayer is a publicly traded company and files Form 10-K. Taxpayer separately reports R&D expenses both as a separate line item on the CAFS and in the Notes to the financial statements. Taxpayer is in the business of developing widgets. Taxpayer used the Revised Directive to determine its QREs for the tax year ending December 31, 2020. Within Appendix C, Step 3 Subtractions from U.S. ASC 730 Financial Statement R&D, taxpayer reports \$1M and \$74M on lines 5 and 6, respectively. These lines include adjustments for costs not allowed per IRC 174 and 41 specifically identified in the Revised Directive and result in a reduction to the US ASC 730 Financial Statement R&D.

Taxpayer provides cost center and trial balance details for the amount reported on Appendix C, line 1, identifying each line item adjustment on Appendix C. The information includes cost center and general ledger detail for depreciation, amortization, shipping, training, general and administrative costs and other items not eligible for IRC 41 expenses. Exam identifies a large negative adjustment (\$20M) on Appendix C, line 6. Without the \$20M adjustment, line 6 would reduce the U.S. ASC 730 Financial Statement R&D by \$94M. Instead, it only reduces the amount by \$74M, which taxpayer explains comes from R&D cost centers. However, Exam discovers taxpayer did not include these accounts on Appendix C, line 1. Taxpayer explains that per ASC 730, when the taxpayer's product meets technical feasibility, additional product costs are transferred from the R&D cost center to cost of goods. However, although the R&D cost center employees perform the additional work on the product in the production phase of development, these associated wages no longer involve ASC 730 activities. Thus, these costs are not included in line 1 of Appendix C and Exam disallows the related adjustments made on line 6.

# Examples of the Process (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

#### Example 3 (cont'd)

A taxpayer is not allowed to make adjustments to Appendix C, lines 2 – 14 for any amount or account (whether positive or negative) that is not included on Appendix C, line 1. If the taxpayer determines an amount meets the requirements of IRC 174 and 41 the costs are entered on Appendix B, Column C. Amounts reported on Appendix B, Column C, are subject to an examination process which includes risk analysis, identification of the business component associated with the expenses and determining whether the taxpayer satisfies the other requirements of IRC 41 and the underlying regulations.

#### Example 4

Taxpayer is a multi-national corporation that develops Enterprise Resource Planning software. Upon walkthrough of the taxpayer's business, Exam noted that taxpayer distributes their software to customers using different methods, including direct download to the customer's device. Taxpayer offers other products online, thus requiring the customer to access the software through the Cloud. Taxpayer's Appendix C does not include any amounts on line 3a or 3b. Taxpayer explains that the Cloud software is for sale and not internal-use so it was not included on line 3a.

Exam confirms the taxpayer's customers do not take possession of the software; rather, the customers access the software on an as-needed basis (that is, customers are unable to download the software and use it independent of the taxpayer's services). Exam concludes that taxpayer's Cloud software is considered a hosting arrangement. Under ASC 985-20-15-5, software offered as part of a hosting arrangement is subject to the rules in ASC 985-20 when both of the following criteria are met:

- The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
- It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

# Examples of the Process (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

#### Example 4 (cont'd)

If one or both criteria are not met, the software is treated as internal-use software subject to ASC 350-40. Here, Exam notes that neither criteria are met so taxpayer's Cloud software is considered internal-use under ASC 350-40.

Taxpayer must quantify the costs of their internal-use software and include the entire amount on line 3a of Appendix C. Doing so removes the costs from Column A of Appendix B. If taxpayer determines that any of the amount reported on Appendix C, line 3a satisfies the requirements of IRC 41 (including the underlying regulations) taxpayer may claim these QREs by reporting the eligible expenses in Column C of Appendix B. Any expenses included in Columns B and C of Appendix B are subject to an examination process, which includes risk analysis, identification of the business component associated with the expenses, and determining whether the taxpayer satisfies the other requirements of IRC 41 and the underlying regulations.

#### Example 5

Taxpayer computes its QREs using the Revised Directive to file its federal income tax return for the year ending August 30, 2020. Taxpayer has two primary business models, one for Software as a Service (SaaS) and the other for the development and sale of product X. Product X is a stand-alone software not subject to a hosting arrangement. On the CAFS, taxpayer reports \$800M in R&D. This amount includes \$300M in R&D for its SaaS activities and \$500M for development of Product X. Taxpayer does not have any foreign subsidiaries and all U.S. subsidiaries file a consolidated return with the taxpayer. Most of the taxpayer's employees work in one division or the other. However, there is a group (Group W) that works in both. The total wages for Group W are \$1M and the amount is allocated 60% to SaaS activities and 40% to Product X.

# Examples of the Process (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

#### Example 5 (cont'd)

Taxpayer completes lines 1 – 4 of the Appendix C and removes the \$300M for the SaaS activities on line 3a and determines that, although these costs are not ASC 730, they are eligible IRC 41 costs. Therefore, taxpayer reports the \$300M SaaS QREs on the appropriate lines on Appendix B, Column C (including 60% of the W-2 wages for Group W). However, taxpayer reports 95% of the full amount of the W-2 wages for Group W (including the 60% allocated to SaaS) on Appendix D, lines 1, 2, 4, and 5. During review of the W-2 information, Exam discovers taxpayer did not properly adjust for the wages removed from Appendix C. Although taxpayer removed the W-2 wages of employees who only work in SaaS, they did not remove the SaaS wages for Group W. Exam adjusts Appendix C, lines 15 & 16 for 60% of wages performed by Group W and reduces the amount the ADJ ASC 730 Financial Statement R&D.

When determining the W-2 wages eligible under the ASC 730 Directive, taxpayers must remove any employee's W-2 wages whose book wages have been removed in lines 1a through 10 on Appendix C.

#### Example 6

Taxpayer is under examination for both tax years 2019 and 2020. Taxpayer followed the Original ASC 730 Directive to calculate their QREs for tax year 2019 and the Revised Directive for tax year 2020. This example illustrates how the taxpayer will arrive at the same U.S. ASC 730 Financial Statement R&D amount under both the 2017 Directive and the Revised Directive.

Taxpayer separately reports Research and Development expenses as a separate line item on the Certified Audited Financial Statements and in the Notes to the financial statement for both years. Taxpayer filed consolidated federal income tax returns including all U.S subsidiaries. For illustration purposes, the taxpayer incurred the same amounts of the R&D expenses and the break-down costs for both years as in the table on the next slide.

# Examples of the Process (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

#### Example 6 (cont'd)

	FACTS	2019	2020
1	Financial Statement R&D (a)	\$1,000	\$1,000
2	R&D related to Foreign Entities (b)	\$ 200	\$ 200
3	Expenses for internal-use software under ASC 350-40 (c)	\$ 100	\$ 100
4	Expenses for internal-use software under ASC 350-40 (c)	\$ 150	\$ 150
	<b>Original ASC 730 Directive</b>		
Line #	Appendix C—Computation of ADJ ASC 730 Financial Statement R&D		
1	<b>ASC 730 Financial Statement R&amp;D</b> <b>Step 1</b>	<b>\$ 750</b>	
2	Subtract: All Amounts Related to Foreign Entities <b>Step 2</b>	(\$ 200)	
3	<b>U.S. ASC 730 Financial Statement R&amp;D</b>	<b>\$ 550</b>	
	<b>Revised Directive</b>		
Line #	Line Description		
1	<b>Financial Statement R&amp;D</b> <b>Step 1</b>		\$ 1,000
1a	Subtract: All amounts related to foreign entities.		(\$ 200)
1b	Subtract: All amounts related to U.S. entities that are not included in taxpayer's consolidated federal income tax return.		\$ 0
2	<b>U.S. Financial Statement R&amp;D (Line 1 minus Line 1a and 1b)</b>		\$ 800
2a	The Schedule M-3 amount (see instructions for Line 2a).		\$ 800
3	<b>Adjustments to U.S. Financial Statement R&amp;D</b> <b>Step 2</b>		
3a	Subtract: Expenses for Software not for sale, lease, or otherwise marketed		\$ 100
3b	Subtract: Expenses identified under ASC 730-10-55-2 or other Non ASC 730 Expenditures.		\$ 150
4	<b>U.S. ASC 730 Financial Statement R&amp;D (Line 2 minus Line 3a and Line 3b)</b>		<b>\$ 550</b>

# Examples of the Process (cont'd)

## Revised ASC 730 Directive - Computing Qualified Research Expenses

### Description

#### Example 6 (cont'd)

#### 2019

Under the Original ASC 730 Directive, line 1 represents ASC 730 Financial Statement R&D. To determine the ASC 730 Financial Statement R&D, taxpayers must adjust any amount included in their financial statement R&D that falls outside the scope of ASC 730. In this example, the \$100 for internal-use software and \$150 for Other Non ASC 730 expenses fall outside the scope of ASC 730. Taxpayers must remove these costs when reporting the amount on line 1. In the 2019 example, the taxpayer would report \$750 on line 1 (\$1,000 Financial Statement R&D - \$100 internal-use software - \$150 Other Non ASC 730). The taxpayer then removes the \$200 related to foreign entities resulting in the U.S. ASC 730 Financial Statement R&D amount of \$550 on line 3.

#### 2020

Under the Revised Directive, line 1 represents Financial Statement R&D. Taxpayer reports on line 1 the entire \$1,000 amount reported as financial statement R&D. Taxpayer then removes the \$200 related to foreign entities. Neither internal-use software nor Other Non ASC 730 expenses fall under the scope of ASC 730. Taxpayer must remove these amounts before determining U.S. ASC 730 Financial Statement R&D.

The Revised Directive has two separate lines to account for these types of costs. In the 2020 example, the taxpayer must remove the \$100 of internal-use software on line 3a and \$150 of the Other Non ASC 730 expenditures on line 3b. These adjustments result in the U.S. ASC 730 Financial Statement R&D amount of \$550 (\$800 U.S. Financial Statement R&D - \$100 internal-use software - \$150 Other Non ASC 730).

As shown in this example, taxpayer reports \$550 of U.S. ASC 730 Financial Statement R&D amounts under both the Original ASC 730 Directive and the Revised Directive.

# Other Considerations / Impact to Audit

ASC 730 Revised Directive - Computing Qualified Research Expenses	
Considerations	Resources
<p>Only individuals authorized to execute the taxpayer's federal income tax return for the taxable year under audit are eligible to sign the Certification Statement contained in either the Original ASC 730 Directive or the Revised Directive. The authorized individual certifies under penalty of perjury that for the applicable taxable year:</p> <ul style="list-style-type: none"> <li>▪ The taxpayer computed the ADJ ASC 730 Financial Statement R&amp;D in accordance with the definitions and methodology set forth in the Directive, and</li> <li>▪ All information provided by the taxpayer in accordance with the Directive, to the best of the authorized individual's knowledge and belief, is true, correct and complete.</li> </ul> <p>For a consolidated federal income tax return, the common parent is the sole agent for the group and will sign the Certification Statement on behalf of the consolidated group.</p>	<ul style="list-style-type: none"> <li>▪ Revised LB&amp;I Directive - <i>Guidance for Allowance of the Credit for Increasing Research Activities under IRC 41 for Taxpayers that Expense Research and Development Costs on their Financial Statements pursuant to ASC 730.</i> (9/20/2020)</li> </ul>
<p>The taxpayer must retain and make available upon request the underlying books and records ("documentation") that support the amounts reported on Revised Directive Appendices B, C and D, and Part V of the Revised Directive. The Territory Manager or his/her delegate can determine a taxpayer is ineligible to apply the Revised Directive when the taxpayer fails to properly retain and timely submit the requested documentation.</p>	



# Other Considerations / Impact to Audit (cont'd)

ASC 730 Revised Directive - Computing Qualified Research Expenses	
Considerations	Resources
<p><u>Documentation</u></p> <p>Documents that taxpayers must retain and make available upon request relating to Appendices C and D of the Revised Directive include, but are not limited to:</p> <ul style="list-style-type: none"> <li>▪ Certified Audited Financial Statement for the credit year including auditor's certifying opinion,</li> <li>▪ Taxpayer's Chart of Accounts,</li> <li>▪ List of U.S. ASC 730 Financial Statement Cost Centers that make up the Financial Statement R&amp;D amount shown in Step 1 of Appendix C,</li> <li>▪ All 730 R&amp;D GL Accounts with account balance details that make up the Financial Statement R&amp;D amount shown in Step 1 of Appendix C,</li> <li>▪ List of R&amp;D GL Accounts with account balances that make up the adjustments in Steps 2 of Appendix C,</li> <li>▪ List of U.S. ASC 730 R&amp;D GL Accounts with account balances that make up the adjustments in Steps 3 and 4 of Appendix C,</li> <li>▪ Taxpayer's supporting documentation showing all employees and levels of management included in the total QREs for the Credit Year,</li> <li>▪ Executed contracts pursuant to which the taxpayer is performing ASC 730 research to comply with the terms of the contract,</li> <li>▪ Executed contracts pursuant to which persons other than employees of the taxpayer are performing ASC 730 research on behalf of the taxpayer (this would include sufficient information to show what research the taxpayer performed outside the U.S.),</li> </ul>	<ul style="list-style-type: none"> <li>▪ Revised LB&amp;I Directive - <i>Guidance for Allowance of the Credit for Increasing Research Activities under IRC 41 for Taxpayers that Expense Research and Development Costs on their Financial Statements pursuant to ASC 730. (9/10/2020)</i></li> </ul>

# Other Considerations / Impact to Audit (cont'd)

ASC 730 Revised Directive - Computing Qualified Research Expenses	
Considerations	Resources
<p><u>Documentation (cont'd)</u></p> <ul style="list-style-type: none"> <li>▪ List of employees with their respective W-2 wage amounts the taxpayer claimed as additions to U.S. ASC 730 Financial Statement R&amp;D in Step 4 of Appendix C. This list would also identify for the applicable taxable year, each employee's job title, reporting level, and the cost center where each of those employees worked,</li> <li>▪ A written narrative of the methodology and calculations for determining the amounts listed on Appendix C, lines 3a and 3b of this Directive. If no amounts are listed on Appendix C, lines 3a and/or 3b of this Directive, explain the methodology utilized to verify none of these expenses are present in the U.S. Financial Statement R&amp;D amount. The explanation should include sufficient information to show that the taxpayer made a reasonable effort to quantify non-ASC 730 Financial Statement R&amp;D, and</li> <li>▪ Substantiation of Internal Control Over Financial Reporting (ICFR) designed to mitigate material misstatement of the taxpayer's expenses reported per financial statements. Substantiation may be provided by a presentation or in writing.</li> </ul>	
<p>The guidelines under the Original ASC 730 Directive and Revised Directive limit the examination scope of the expenditures calculated in Steps 1 through 5. However, this does not prevent the taxpayer from reporting other costs on the Form 6765 - <i>Credit for Increasing Research Activities</i>. The benefit of the Original ASC 730 Directive and Revised Directive only applies to the amount determined as the ADJ ASC 730 Financial Statement R&amp;D QRE amounts.</p>	

# Other Considerations / Impact to Audit (cont'd)

<b>ASC 730 Revised Directive - Computing Qualified Research Expenses</b>	
<b>Considerations</b>	<b>Resources</b>
<p>Exam teams receiving assigned returns where the taxpayer follows the Directive should use:</p> <ul style="list-style-type: none"> <li>▪ Project Code 6750 – LB&amp;I Research and Experimentation Credit IIR and</li> <li>▪ Tracking Code 1511 – LB&amp;I Directive – Credit for Increasing Research Activities under IRC 41.</li> </ul>	
<p>Examiners should conduct a risk analysis of the additional QREs the taxpayer reported. Any QREs the taxpayer reported on Form 6765 for the credit year that exceed the Adjusted ASC 730 Financial Statement R&amp;D QRE Amount are subject to an examination process which includes risk analysis, identification of the business component associated with the expenses and determining whether the taxpayer satisfies the other requirements of IRC 41 and the underlying regulations. The audit team determines the scope and depth of the examination based on the taxpayer's facts and circumstances and its reporting of QREs on the Form 6765. Risking the additional QREs involves at a minimum, reviewing the Appendix B, the details explained in the Example of the Process and understanding the taxpayer's research activities.</p>	
<p>Taxpayer must properly retain and timely submit (within a time period subject to LB&amp;I IDR enforcement process) the documentation listed in Part V of this Directive. This documentation must support, to the satisfaction of Exam, that the amounts reported on Appendices C &amp; D are true, correct and follow Steps 1 through 5 of this Process Unit and are certified (as required by the Revised Directive).</p>	
<p>The Revised Directive is an internal directive to LB&amp;I examiners and is not binding in Appeals. Appeals may look at the taxpayer's IRC 41 QREs that can be substantiated, and not the QREs determined using the Revised Directive's methodology, to resolve the issue.</p>	

# Index of Referenced Resources

<b>ASC 730 Revised Directive - Computing Qualified Research Expenses</b>
IRC 41
IRC 41(b)
IRC 41(d)(4)
IRC 174
IRC 174(a)
IRC 3401
Treas. Reg. 1.41
Treas. Reg. 1.174
<i>ASC 730 - Research and Development</i>
FAA 20131102F – Treatment of Voluntary Separation Payments as Qualified Research Expenditures Under IRC 41
Form 1120, Schedule M-3 - <i>Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More</i>
Form 6765 - <i>Credit for Increasing Research Activities</i>
Form 10-K - <i>Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934</i>
LB&I Revised Directive - <i>Guidance for Allowance of the Credit for Increasing Research Activities under IRC 41 for Taxpayers that Expense Research and Development Costs on their Financial Statements pursuant to ASC 730 (9/10/2020)</i>
LB&I Directive - <i>Guidance for Allowance of the Credit for Increasing Research Activities under IRC 41 for Taxpayers that Expense Research and Development Costs on their Financial Statements pursuant to ASC 730 (9/11/2017)</i>
FAQs - <i>IRC 41 QREs and ASC 730 LB&amp;I Directive</i>

# Training and Additional Resources

## ASC 730 Revised Directive - Computing Qualified Research Expenses

Type of Resource	Description(s)
Reference Materials	▪ Audit Techniques Guide - <i>Credit for Increasing Research Activities ( Research Tax Credit)</i> <i>IRC 41</i>

# Glossary of Terms and Acronyms

Term/Acronym	Definition
Adjusted ASC 730 R&D	Adjusted ASC 730 Financial Statement Research and Development
ASC	Accounting Standards Codification
Exam	The Exam Team
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principle
GL	General Ledger
IDR	Information Document Request
IRC	Internal Revenue Code
LB&I	Large Business & International
QIC	Qualified Individual Contributor
QREs	Qualified Research Expenditures
R&D	Research and Development

# Index of Related Practice Units

<b>Associated UIL(s)</b>	<b>Related Practice Unit</b>
41.00	<i>ASC 730 Research and Development - How It Relates to IRC 41 and 174</i>
41.00	<i>ASC 730 Directive - Computing Qualified Research Expenses</i>