

LB&I Concept Unit

Knowledge Base – Corporate/Business Issues & Credits

Library Level	Number	Title
Shelf		General Business and Energy Credits
Book	272	Credit for Increasing Research Activities - Section 41
Chapter	7	Administrative Procedures (Related to Research Credit)
Section	1	LB&I Procedures

Unit Name	ASC 730 Research and Development - How It Relates to IRC 41 and 174	
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General Overview

ASC 730 Research and Development - How It Relates to IRC 41 and 174

This Concept Unit provides examiners an overview of Accounting Standards Codification (ASC) 730 Research and Development and how it relates to IRC 41 and 174.

ASC 730 is a Generally Accepted Accounting Principle (GAAP) standard and establishes the financial accounting and reporting for research and development (R&D) activities and costs. The activities identified in ASC 730 have many similarities with the activities treated as research under IRC 41 and 174. Under ASC 730, the taxpayer reports R&D costs, when determined to be material in amount, as a separate line item on the Certified Audited Financial Statement.

Various regulating entities govern the preparation of Certified Audited Financial Statements such as the:

- U.S. Securities and Exchange Commission (SEC), which has primary responsibility for
 - Enforcing the federal securities laws,
 - Regulating the securities industry, and
 - Overseeing the Sarbanes-Oxley Act of 2002 (SOX), which provides additional oversight in the accounting profession regarding the preparation and review of financial statements for publicly held companies.
- Financial Accounting Standards Board (FASB), which establishes financial accounting and reporting standards for public and private companies that follow GAAP;
- American Institute of Certified Public Accountants (AICPA), which establishes the Code of Professional Conduct for Certified Public Accountants; and
- Public Company Accounting Oversight Board (PCAOB), which establishes auditing and related professional practice standards such as Generally Accepted Auditing Standards (GAAS) for registered public accounting firms.

General Overview (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Failure to follow the established federal security laws and accounting standards can result in severe penalties. SOX asserts strong sentencing guidelines for white-collar crimes, such as failure to certify corporate financial reports. The PCAOB can assess civil penalties or revoke a public accounting firm's accounting registration for failed inspections or for failing to follow the PCOAB guidelines.

The user of Certified Audited Financial Statements prepared in accordance with the above standards can reasonably expect those statements to be free from material misstatements. This, coupled with the oversight of the accounting profession and the similarities between ASC 730 and IRC 41 and 174 (as identified in the following slides), provides reasonable assurance that examiners can rely on the ASC 730 R&D amount separately reported in Certified Audited Financial Statements as the starting point in determining qualified research expenses (QREs).

Relevant Key Factors

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Key Factors

This section provides a brief overview of ASC 730, ASC 350-40 (Internal-Use Software), and ASC 985-20 (Costs of Software to be Sold, Leased, or Marketed). We included ASC 350-40 and ASC 985-20 here because sections of these ASC standards have ASC 730 implications.

ASC 730 Research and Development

GAAP contains many pronouncements, one of which is ASC 730 Research and Development. ASC 730 requires corporations to disclose the amount of costs for company and customer-sponsored research and development activities, if material (as determined by the taxpayer and financial auditors). The costs include wages, supplies, contract research and indirect costs associated with research.

Activities

ASC 730-10-20 defines research and development activities.

Research is the planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing:

- A new product or service (referred to as product), or
- A new process or technique (referred to as process), or
- In bringing about a significant improvement to an existing product or process.

Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants.

Relevant Key Factors (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Key Factors

Costs

ASC 730 summarizes and defines the costs associated with research and development activities and their individual accounting treatment in the context of financial statement presentation.

Generally, for book purposes the taxpayer expenses all costs associated with the research and development of products in the period in which it incurs the costs. The cost of materials, equipment, facilities, personnel salaries or wages, contract services, and applicable overhead or indirect costs are all expensed as part of research and development under ASC 730.

The amount reported as ASC 730 R&D costs on Certified Audited Financial Statements prepared in accordance with GAAP can serve as a starting point to isolate QREs.

Other Applicable ASC Sections

For software development, there are two specific ASC sections, ASC 350-40 (Internal-Use Software) and ASC 985 (Software to be Sold, Leased or Marketed) that can have an impact on the activities and costs reported under ASC 730.

ASC 350-40: Internal-Use Software

ASC 350-40 provides guidelines on the treatment of software the taxpayer develops for internal use. Even though ASC 350-40 normally covers costs associated with the development of internal-use software, there exist rare instances in which ASC 730 treats software for internal use as ASC 730 costs. For example, costs for software the taxpayer developed for use in an actual research and development activity apart from the software development may qualify as ASC 730 costs. This is similar to the rules under Treas. Reg. 1.41-4(c)(6)(ii)(A).

Relevant Key Factors (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Key Factors

ASC 985-20: Costs of Software to be Sold, Leased, or Marketed

ASC 985-20 provides guidelines for software that the taxpayer develops to sell, lease, or otherwise market. Selling, leasing, or otherwise marketing software requires more than simply planning to generate revenue with the software. For example, software developed for customers in which they can contractually take possession of the software and run it on their own hardware rather than simply accessing it online is software for sale, lease or market. By contrast, most online software and cloud computing services are not software the vendor sells, leases, or otherwise markets. Utilized in providing services, this software follows the internal use software standard under 350-40 rather than the externally marketed software standard under ASC 985.

Some costs associated with the development of software the taxpayer intends to sell, lease, or market are ASC 730 costs. ASC 985-20-25-1 states, "All costs incurred to establish the technological feasibility of a computer software product to be sold, leased, or otherwise marketed are research and development costs. Those costs shall be charged to expense when incurred as required by Subtopic 730-10," i.e., the costs are treated as ASC 730 costs. However, ASC 985-20-25-2 further states, "for purposes of this Subtopic, the technological feasibility of a computer software product is established when the entity has completed all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications including functions, features, and technical performance requirements." At the point the software meets technological feasibility, the activities and costs are no longer ASC 730 activities and costs.

The following slides under "Detailed Explanation of the Concept" provide an overview and discussion of ASC 730, IRC 174 and 41 for the activities and costs reported under each and are not all-inclusive or exact citations of ASC 730, IRC 174 or 41. The Internal Use Software (IUS) regulations discussed in this section relate to the 2016 final Treasury Regulations (prospective only). For questions related to Treasury Regulations on IUS, please contact the General Business Credits Practice Network (GBC PN).

Detailed Explanation of the Concept

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Identify key features of ASC 730 and how they relate to IRC 41 and 174.

Analysis	Resources
<p><u>Definitions – Research</u></p> <ul style="list-style-type: none">▪ ASC 730 Research<ul style="list-style-type: none">– Research is the planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (referred to as “product”), or a new process or technique (referred to as “process”), or in bringing about a significant improvement to an existing product or process.▪ IRC 41<ul style="list-style-type: none">– Research (defined in part) is undertaken for the purpose of discovering technical information if it is intended to eliminate uncertainty concerning the development or improvement of a separate and distinct business component (product or process). Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.	<ul style="list-style-type: none">▪ ASC 730-10-20▪ Treas. Reg. 1.41-4(a)(3)

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis

Resources

Definitions – Research (cont'd)

- Comments

- Underlying both ASC 730 and IRC 41 is the recognition that research requires obtaining new knowledge or technical information in the development of a separate and distinct product or process.

Definitions – Development

- ASC 730

- Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants.

- IRC 41

- Process of Experimentation (POE) related to a separate and distinct business component:
 - IRC 41 requires a taxpayer to identify the uncertainty regarding the development or improvement of a business component that is the object of the taxpayer's research activities,

- ASC 730-10-20
- Treas. Reg. 1.41-4(a)(5)

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis

Resources

Definitions – Development (cont'd)

- IRC 41(cont'd)
 - IRC 41 requires a taxpayer to identify one or more alternatives intended to eliminate that uncertainty, and
 - IRC 41 requires a taxpayer to identify and to conduct a process of evaluating the alternatives. This may involve modeling, simulation, or a systematic trial and error methodology.

- Comments
 - Conceptual formulation, design, testing of product alternatives, and construction of prototypes related to separate and distinct business components may be activities involved in a POE.

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Definitions - Technological Activities</u></p> <ul style="list-style-type: none"> ▪ ASC 730 <ul style="list-style-type: none"> - Activities under ASC 730 include laboratory research aimed at discovery of new knowledge and disallowing seasonal or other periodic design changes to existing products. ▪ IRC 41 and 174 <ul style="list-style-type: none"> - IRC 41 requires research undertaken for the purpose of discovering information that is technological in nature and the intent of the application assists in developing a new or improved business component. - Costs incurred in a taxpayer's trade or business representing research and development expenditures are costs in an experimental or laboratory sense. - IRC 41(d) disallows as a qualifying purpose, research if it relates to style, taste, cosmetic, or seasonal design factors. ▪ Comments <ul style="list-style-type: none"> - ASC 730, IRC 41 and 174 undertake activities for the purpose of discovering of new information through laboratory (i.e., scientific) research and exclude as research those activities related to style, taste, cosmetic, or seasonal design factors. 	<ul style="list-style-type: none"> ▪ ASC 730-10-55-1a ▪ ASC 730-10-55-2f ▪ IRC 41(d)(1)(B) ▪ Treas. Reg. 1.174-2

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Definitions – Product/Process vs Business Component</u></p> <ul style="list-style-type: none"> ▪ ASC 730 <ul style="list-style-type: none"> – ASC 730 applies to activities targeted at developing or improving a product or service (referred to as product) or a process or technique (referred to as process) whether the taxpayer intends to sell or use the product or process. A process may be a system whose output the taxpayer intends to sell, lease, or otherwise market to others. The taxpayer may also use a process internally as a part of a manufacturing activity or a service activity where the taxpayer markets the service itself. ▪ IRC 41 and 174 <ul style="list-style-type: none"> – Under Treas. Reg. 1.174-2(a)(3), the term "product" includes any pilot, model, formula, invention, technique, patent, or similar property. IRC 41(d)(2)(B) defines a business component used for purposes of the credit as any product, process, computer software, technique, formula, or invention to be held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer. ▪ Comments <ul style="list-style-type: none"> – A product or process under ASC 730 is essentially like a “product” defined under IRC 41 and 174. 	<ul style="list-style-type: none"> ▪ ASC 730-10-15 ▪ IRC 41(d)(2)(B) ▪ Treas. Reg. 1.174-2(a)(3)

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Transactions</u></p> <ul style="list-style-type: none"> ▪ ASC 730 does not include the following transactions: <ul style="list-style-type: none"> - Activities conducted for others under a contractual arrangement (which is a part of accounting for contracts in general), - The acquisition, development, or improvement of a process by an entity for use in its selling or administrative activities, - Routine or periodic alterations to existing products, production lines, manufacturing processes, and other ongoing operations even though those alterations may represent improvements, and - Market research or market testing activities. ▪ IRC 41 <ul style="list-style-type: none"> - Research activities where a taxpayer conducts qualified research for others may qualify if it is not funded research. - Treas. Reg. 1.41-4(c)(6) treats software developed for use in general and administrative functions (G&A) as Internal Use Software (IUS). If the taxpayer meets the additional three-part High Threshold of Innovation test, (i.e., the software is innovative, involves significant economic risk, and is not commercially available) as provided in Treas. Reg. 1.41-4(c)(6)(vii), and meets the IRC 41(d) four-part test as explained in Chapter 4 of the Audit Techniques Guide for Credit for Increasing Research Activities (i.e., Research Tax Credit) IRC 41 (ATG-RTC), the taxpayer includes the qualifying costs as QREs. - Routine testing, data collection, and market research and testing do not qualify. 	<ul style="list-style-type: none"> ▪ ASC 730-10-15-4 ▪ IRC 41(d)(4) ▪ Treas. Reg. 1.41-4(c)(6) ▪ Audit Techniques Guide - <i>Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC 41</i>

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Transactions (cont'd)</u></p> <ul style="list-style-type: none"> ▪ Comments <ul style="list-style-type: none"> – Typically, ASC 730 excludes costs associated with activities a taxpayer conducts for others under a contractual arrangement. IRC 41 allows these costs if: <ul style="list-style-type: none"> ▪ The rights and risks belong to the taxpayer, ▪ The performance of the activities occurs in the U.S. and ▪ The activity meets the IRC 41(d) four-part test as referenced in the previous slide. – Costs associated with development or improvement of a process involving G&A functions do not qualify under ASC 730, but could qualify if the activity meets the IRC 41(d) four-part test. If the process involves IUS, the three-part High Threshold of Innovation test applies. 	<ul style="list-style-type: none"> ▪ IRC 41(d) ▪ Audit Techniques Guide - <i>Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC 41</i>

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Excluded Activities</u></p> <ul style="list-style-type: none">▪ Examples of ASC 730 excluded activities include:<ul style="list-style-type: none">– Engineering follow-through in an early phase of commercial production,– Quality control during commercial production, including routine testing of products,– Trouble-shooting in connection with break-downs during commercial production,– Routine, ongoing efforts to refine, enrich, or otherwise improve upon the qualities of an existing product,– Adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity,– Seasonal or other periodic design changes to existing products,– Routine design of tools, jigs, molds, and dies,– Activities, including design and construction engineering, related to the construction, relocation, rearrangement, or start-up of facilities or equipment other than the following:<ul style="list-style-type: none">▪ Pilot plants (but see "Allowed Activities" later in the Unit),▪ Facilities or equipment whose sole use is for a specific research and development project (see ASC 730-10-25-2[a]),– Legal work in connection with patent applications or litigation, and the sale or licensing of patents.	<ul style="list-style-type: none">▪ ASC 730-10-55-2▪ IRC 41(d)(4)

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Excluded Activities (cont'd)</u></p> <ul style="list-style-type: none"> ▪ IRC 174 and 41 exclude similar activities plus: <ul style="list-style-type: none"> - Advertising or promotions, - Research in connection with literary, historical, or similar projects, - Reverse engineering, - Studies and surveys (includes market research), - Internal use software requires additional tests, - Foreign research, - Social sciences, and - Funded Research. ▪ Comments <ul style="list-style-type: none"> - The excluded activities under ASC 730, IRC 174 and 41 are generally the same. ASC 730-10-15-4 does not provide guidance for R&D conducted for others under contract, market research and testing, selling and admin activities, and routine and periodic alterations. - IRC 41 may allow the costs associated with the qualified activities for the development of IUS if the software meets the IRC 41(d) four-part test and the three-part High Threshold of Innovation test (as identified previously). Also, IRC 41 allows activities a taxpayer conducts for others under a contractual arrangement if the rights and risks of the contract belong to the taxpayer and the activities meet the IRC 41(d) four-part test. 	<ul style="list-style-type: none"> ▪ ASC 730-10-15-4 ▪ IRC 41(d)(4) ▪ Treas. Reg. 1.174-2(a)(6) ▪ Audit Techniques Guide - <i>Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC 41</i>

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Allowed Activities</u></p> <ul style="list-style-type: none">▪ Examples of ASC 730 activities considered research and development include:<ul style="list-style-type: none">- Laboratory research to discover new knowledge,- Searching for applications of new research findings or other knowledge,- Conceptual formulation and design of possible product or process alternatives,- Testing in search for or evaluation of product or process alternatives,- Modification of the formulation or design of a product or process,- Design, construction, and testing of preproduction prototypes and models,- Designing tools, jigs, molds, and dies involving new technology,- Design, construction, and operation of a pilot plant that is not of a scale economically feasible to the entity for commercial production,- Engineering activities to advance the design to the point that the activities meet specific functional and economic requirements and are ready for manufacture, or- Design and development of tools used to facilitate research and development or components of a product or process that are undergoing research and development activities.	<ul style="list-style-type: none">▪ ASC 730-10-55-1

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Allowed Activities (cont'd)</u></p> <ul style="list-style-type: none"> ▪ IRC 41 and 174 <ul style="list-style-type: none"> – IRC 41 does not specifically provide a list of qualifying activities like those identified under ASC 730. Instead, IRC 41 and 174 identify the required traits that activities must have to qualify as research. – Treas. Regs. 1.41-4(a)(6) and 1.174-2(a)(5) allow for a shrink-back method to identify qualifying research when the whole business component does not qualify. ▪ Comments <ul style="list-style-type: none"> – The following activities found under ASC 730 (not an exclusive list) typically would not qualify under IRC 41 and 174: <ul style="list-style-type: none"> ▪ Searching for applications of new research findings if the research was for a non-technical product (like literary work), ▪ Performing conceptual formulation activities related to a customer to identify what they want in a product, ▪ Evaluating third-party products (unless in a qualified POE), ▪ Developing screen layout design based on fonts, colors, sounds, and ▪ Claiming for a whole pilot plant; the entire pilot and all subcomponents would require uncertainty in an experimental or laboratory sense regarding capability or method for improving the business component. – ASC 730 does not identify a shrink-back rule/method. 	<ul style="list-style-type: none"> ▪ ASC 730-10-55-1 ▪ Treas. Reg. 1.41-4(a)(6) ▪ Treas. Reg. 1.174-2(a)(5)

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Software Activities</u></p> <ul style="list-style-type: none"> ▪ ASC 730/350-40 <ul style="list-style-type: none"> – Internal-use software includes software acquired, internally developed, or modified solely to meet the entity’s internal needs and during the software development or modification, no substantive plan exists to market it externally. Additionally, internal-use software includes software used in the production of a product or in providing a service but where the customer does not acquire the software or the future right to use it. ASC 350-40-15-7 includes the following activities of internal use computer software in R&D and taxpayers should account for them in accordance with the provisions of Subtopic 730-10: <ul style="list-style-type: none"> ▪ Purchased or leased computer software used in research and development activities where the software does not have alternative future uses, or ▪ All internally developed internal use computer software (including software developed by third parties, for example, programmer consultants) in either of the following circumstances: <ul style="list-style-type: none"> – The software is a pilot project (that is, software of a nature like a pilot plant as noted in ASC 730-10-55-1(h)), or – The taxpayer uses the software in a specific research and development project, regardless of whether the software has alternative future uses. 	<ul style="list-style-type: none"> ▪ ASC 350-40-15 ▪ ASC 730-10-55-1(h) ▪ Treas. Reg. 1.41-4(c)(6)

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Software Activities (cont'd)</u></p> <ul style="list-style-type: none"> ▪ IRC 41 <ul style="list-style-type: none"> - The 2016 final IUS regulations define IUS as computer software developed by (or for the benefit of) the taxpayer primarily for their internal use in G&A functions that facilitate or support the conduct of the taxpayer's trade or business. This IUS regulation includes as IUS, dual function software developed for use in G&A functions and (at least one of the following) <ul style="list-style-type: none"> ▪ to enable a taxpayer to interact with third parties, or ▪ to allow third parties to initiate functions or review data on the taxpayer's system. - IRC 41 allows as qualifying research, IUS that passes the additional three-part High Threshold of Innovation test. - Software developed for use in an activity that constitutes qualified research (other than the development of IUS itself) need not apply the three-part High Threshold of Innovation test. 	<ul style="list-style-type: none"> ▪ ASC 350-40-15-4b ▪ Treas. Reg. 1.41-4(c)(6) ▪ Audit Techniques Guide - <i>Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC 41</i>

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Software Activities (cont'd)</u></p> <ul style="list-style-type: none"> ▪ Comments <ul style="list-style-type: none"> - Typically, the taxpayer accounts for internal-use software under GAAP ASC 350-40 and not ASC 730. - ASC 730 only includes internal-use software when: <ul style="list-style-type: none"> ▪ The software is a pilot project similar to a pilot plant under ASC 730-10-55-1 (relatively rare), or ▪ The taxpayer uses the software in a particular research project that is similar to the exclusion for software used in a qualifying research activity under Treas. Reg. 1.41-4(c)(6)(ii)(A). This exclusion removes the additional three-part High Threshold of Innovation Test. - ASC 350-40 accounts for dual function software. Dual function software supports or facilitates both G&A functions and the provision of services. Dual function software does not include software developed for sale, lease, or otherwise market as defined in ASC 350-40 or ASC 985. 	<ul style="list-style-type: none"> ▪ ASC 350-40-15-4b ▪ Treas. Reg. 1.41-4(c)(6) ▪ Audit Techniques Guide - <i>Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC 41</i>

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Costs – Salaries and Wages</u></p> <ul style="list-style-type: none"> ▪ ASC 730 <ul style="list-style-type: none"> – Salaries, wages, and other related costs of personnel “engaged” in research is R&D. ▪ IRC 41 and 174 <ul style="list-style-type: none"> – IRC 41 include as QREs only salaries, wages, stock options, etc., (any amount included in W-2 taxable income) for: (i) engaging in qualified research, or (ii) engaging in the direct supervision or direct support of research activities which constitute qualified research. – R&D expenditures for salaries and wages must be reasonable. ▪ Comments <ul style="list-style-type: none"> – IRC 41 excludes wages paid for indirect support. Second level supervisors do not qualify unless the second level supervisor is performing research or directly supervising individuals performing qualified research activities. IRC 41 only allows supervisor wages to the extent of time their activities involve supervising those individuals conducting qualified research activities. – Under IRC 174, wages (along with other allowed expenditures) must be reasonable, i.e., the amount that like entities would ordinarily pay for like activities under like circumstances. No reasonableness limitations exist in ASC 730. – Work Opportunity Tax Credit wages are not QREs. 	<ul style="list-style-type: none"> ▪ ASC 730-10-25-2b ▪ IRC 41(b)(2)(B) ▪ IRC 174(e)

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p data-bbox="87 382 706 415"><u>Materials, Equipment, Facilities, or Supplies</u></p> <ul style="list-style-type: none"> <li data-bbox="87 475 240 508">▪ ASC 730 <ul style="list-style-type: none"> <li data-bbox="111 522 969 555">– ASC 730 allows the costs of materials consumed in R&D. <li data-bbox="111 569 1404 636">– ASC 730 capitalizes and allows depreciation of the costs for equipment and facilities that have alternative future uses in R&D. <li data-bbox="111 651 1404 718">– ASC 730 allows costs of materials, equipment, or facilities that have no alternative future uses as R&D costs at the time the taxpayer incurs the costs. <li data-bbox="87 779 337 812">▪ IRC 41 and 174 <ul style="list-style-type: none"> <li data-bbox="111 826 1338 859">– IRC 41 includes as QREs supplies consumed (used) in qualifying research activities. <li data-bbox="111 873 1390 1093">– IRC 41 can include direct labor and material costs associated with a “pilot model.” IRC 41 defines a “pilot model” as any representation or model of a product that the taxpayer produces 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 a product (to the extent the shrinking-back rule applies). <li data-bbox="111 1108 1292 1175">– IRC 174 allows the depreciation or depletion on acquisition costs of land or other property the taxpayer uses in connection with R&D activities. IRC 41 does not. 	<ul style="list-style-type: none"> <li data-bbox="1423 382 1721 415">▪ ASC 730-10-25-2a <li data-bbox="1423 429 1628 462">▪ IRC 41(b)(3) <li data-bbox="1423 476 1605 509">▪ IRC 174(c)

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Materials, Equipment, Facilities or Supplies (cont'd)</u></p> <ul style="list-style-type: none"> ▪ Comments <ul style="list-style-type: none"> – IRC 41 and 174 do not include the costs of facilities and equipment of a character subject to an allowance for depreciation, and although IRC 174 allows depreciation, IRC 41 does not. – For equipment and facilities costs identified in ASC 730 to qualify under IRC 41, those costs would need to qualify as a “pilot model” (defined under 1.174-2(a)(4)). This requires use of the pilot model in activities meeting the definition of “qualified research” as explained in IRC 41(d), and meeting the IRC 41(d) four-part test. (See the ATG-RTC). – The costs of the pilot model would include only the direct labor and materials used in the development of the model. Overhead and indirect costs would not qualify as part of the costs of the pilot model. – ASC 730 allows the expense of equipment that has no alternative future uses as R&D costs. For IRC 41, the taxpayer would need to consume the equipment in the research. 	<ul style="list-style-type: none"> ▪ ASC 730-10-25-2a ▪ IRC 41(b)(3) ▪ Treas. Reg. 1.174-2(a)(4) ▪ Audit Techniques Guide -- <i>Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC 41</i>

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Contract Services</u></p> <ul style="list-style-type: none">▪ ASC 730<ul style="list-style-type: none">- ASC 730 includes services performed by others (i.e., for a contract) in connection with R&D and the costs of research performed by others.▪ IRC 41<ul style="list-style-type: none">- In computing the amount of QREs attributable to contracted research, IRC 41 generally reduces the contract research expense to 65% of the qualifying research cost.▪ Comments<ul style="list-style-type: none">- ASC 730 and IRC 41 allow contract service costs as QREs when a taxpayer has a right to the research results and the contract requires the taxpayer to bear the expense even if the research is not successful. The services contractors provide have the same rules and limitations regarding excluded costs and activities.	<ul style="list-style-type: none">▪ ASC 730-10-25-2d▪ IRC 41(b)(3)

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Costs – Foreign Corporation and Foreign Research</u></p> <ul style="list-style-type: none"> ▪ ASC 730 <ul style="list-style-type: none"> – Costs under ASC 730 include costs for all entities in the group, including foreign entities. In addition, they include costs incurred outside of the United States for entities located within the United States. ▪ IRC 41 <ul style="list-style-type: none"> – IRC 41 does not include any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States. – Treas. Reg. 1.41-6 determines the amount of the credit based on the controlled group rules. Under IRC 41(f)(5), a controlled group of corporations has the same meaning given under IRC 1563(a) except that IRC 41(f)(5) replaces “at least 80%” of total combined voting power with “more than 50%.” ▪ Comments <ul style="list-style-type: none"> – IRC 41 excludes from QREs the costs associated with research conducted by a foreign entity or by other entities performing research outside the U.S. and its territories, even if the taxpayer treats a foreign entity as a disregarded entity and files a U.S. federal income tax return with a consolidated group of corporations. 	<ul style="list-style-type: none"> ▪ IRC 41(d)(4)(F) ▪ Treas. Reg. 1.41-6

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Costs Associated with Other Excluded Activities</u></p> <ul style="list-style-type: none">▪ ASC 730<ul style="list-style-type: none">- ASC 730 does not include costs associated with excluded activities . (See earlier “Activities” discussion for specific activities).▪ IRC 41 and 174<ul style="list-style-type: none">- Costs associated with social sciences, reverse engineering, market research and testing, and funded research do not qualify as QREs.▪ Comments<ul style="list-style-type: none">- ASC 730, IRC 41 and IRC 174 do not allow the costs associated with excluded activities.	<ul style="list-style-type: none">▪ ASC 730-10-55-2▪ IRC 41(d)(4)▪ Treas. Reg. 1.174-2(a)(6)

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Purchased Intangible Assets</u></p> <ul style="list-style-type: none"> ▪ ASC 730 <ul style="list-style-type: none"> - ASC 730 should not include the costs of intangibles purchased from others for use in R&D that have alternative future uses. The amortization from these assets is an ASC 730 cost. - If the intangible asset does not have an alternative future use, it is an ASC 730 cost. ▪ IRC 41 and 174 <ul style="list-style-type: none"> - IRC 41 allows as a QRE “supplies” used in the conduct of qualified research. - IRC 41 defines “supplies” as any tangible property other than: (i) land or improvements to land, and (ii) property of a character subject to the allowance for depreciation. - The acquisition costs of another’s patent, model, production, or process are not IRC 174 or 41 expenses. However, IRC 174 allows but, IRC 41 does not allow the amortization of a patent used in qualifying research. ▪ Comments <ul style="list-style-type: none"> - If a patent, has alternative future uses, then ASC 730 allows amortization of acquisition costs. IRC 174 allows amortization of acquisition costs associated with a patent used in qualifying research but, IRC 41 does not allow any amortization of costs. 	<ul style="list-style-type: none"> ▪ ASC 730-10-25-2c ▪ IRC 41(b)(2)(C) ▪ Treas. Reg. 1.174-2(a)(6)

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis	Resources
<p><u>Indirect Costs</u></p> <ul style="list-style-type: none">▪ ASC 730<ul style="list-style-type: none">- Research and development costs include a reasonable allocation of indirect costs. However, the taxpayer should not include G&A costs that are not clearly related to research and development activities as research and development costs.▪ IRC 41<ul style="list-style-type: none">- IRC 41 allows as QREs, qualifying wages, supplies, and contract labor costs.- Supplies that are indirect research expenditures or G&A expenses do not qualify as QREs.▪ Comments<ul style="list-style-type: none">- The taxpayer should not include Indirect costs, whether they are supplies, contract costs, wages, or other indirect costs, as QREs in calculating the research credit.	<ul style="list-style-type: none">▪ ASC 730-10-25-2e▪ IRC 41(b)▪ Treas. Reg. 1.41-2

Detailed Explanation of the Concept (cont'd)

ASC 730 Research and Development - How It Relates to IRC 41 and 174

Analysis

Resources

Summary

As shown in this Unit, there are similarities between ASC 730, IRC 174 and 41. ASC 730 allows costs associated with some activities that do not qualify under IRC 174 and 41. In addition, IRC 174 and 41 allow as QREs costs associated with activities that ASC 730 does not include.

Overall, based on the similarities and acknowledging and adjusting for the costs included in ASC 730 that are neither IRC 174 or 41 expenditures, the amount the taxpayer reported as ASC 730 Research and Development on Certified Audited Financial Statements prepared in accordance with GAAP can be a starting point for determining QREs.

Index of Referenced Resources

ASC 730 Research and Development - How It Relates to IRC 41 and 174

ASC 350-40

ASC 730-10

ASC 985-20

IRC 41

IRC 174

Treas. Reg. 1.41-2

Treas. Reg. 1.41-4

Treas. Reg. 1.41-6

Treas. Reg. 1.174-2

Audit Techniques Guide - *Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC 41*

Training and Additional Resources

ASC 730 Research and Development - How It Relates to IRC 41 and 174	
Type of Resource	Description(s)
White Papers / Guidance	<ul style="list-style-type: none"> ▪ 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</i> (9/11/17)
Databases / Research Tools	<ul style="list-style-type: none"> ▪ FASB Website ▪ Investopedia - FASB
Reference Materials – Treaties	<ul style="list-style-type: none"> ▪ PCAOB - <i>Staff Audit Practice Alert No. 10: Maintaining and Applying Professional Skepticism in Audits</i> (12/4/12) ▪ PCAOB - <i>AS 1005: Independence</i> ▪ AU-C Section 200 - <i>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards</i>

Glossary of Terms and Acronyms

Term/Acronym	Definition
AICPA	American Institute of Certified Public Accountants
ASC	Accounting Standards Codification
ATG-RTC	Audit Techniques Guide for Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC 41
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
G&A	General and Administrative
GBC PN	General Business Credits Practice Network
IRC	Internal Revenue Code
IUS	Internal Use Software
PCAOB	Public Company Accounting Oversight Board
POE	Process of Experimentation
QREs	Qualified Research Expenditures under IRC 41
R&D	Research and Development
SEC	Securities Exchange Commission

Glossary of Terms and Acronyms (cont'd)

Term/Acronym	Definition
SOX	Sarbanes-Oxley Act
Treas. Reg.	Treasury Regulation

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
	None at this time	