

LB&I Process 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 Directive - Computing Qualified Research Expenses	
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Process Overview

ASC 730 Directive - Computing Qualified Research Expenses

Examining the research credit involves significant resources of both taxpayers and the Internal Revenue Service. Taxpayers who incur research and development (R&D) expenditures and follow U.S. Generally Accepted Accounting Principles (GAAP) for book, account for those expenditures following Accounting Standards Codification (ASC) Topic 730: Research and Development. 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 book ASC 730 R&D costs, less specifically excluded costs (e.g., indirect costs, foreign research, quality control, etc.), may assist the exam team in significantly reducing the scope of the examination and the resources required for the taxpayer and the Service.

On September 11, 2017, the Commissioner of the Large Business & International Division (LB&I) issued a 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," hereafter referred to as "Directive." The purpose of the Directive is to provide an efficient manner for determining QREs.

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

Process Overview (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

This Process Unit explains the Directive, and the 5 steps (Steps 1 – 5) an LB&I taxpayer takes to adjust (for tax) the amount reported as the ASC 730 R&D costs on its Certified Audited Financial Statement in determining its QREs. These adjustments reconcile the differences between ASC 730 expenditures and those allowed under IRC 174 and IRC 41. In addition, this Process Unit also provides 4 optional steps (Steps 6 – 9) that provide information to the exam team for determining the scope of the research credit examination. Step 10 explains how the taxpayer reconciles the QREs claimed on the Form 6765 - *Credit for Increasing Research Activities*.

The Directive and this Process Unit only apply to LB&I taxpayers who follow U.S. GAAP to prepare their Certified Audited Financial Statements. The Certified Audited Financial Statements must show the amount of the currently expensed ASC 730 Financial Statement R&D costs as a separate line item on the income statement or separately state the ASC 730 R&D costs in a note to the Certified Audited Financial Statements. The Directive and this Process Unit apply only to original returns timely filed (including extensions) by LB&I taxpayers on or after September 11, 2017. The Directive requires the examiner to accept as sufficient evidence of QREs the Adjusted ASC 730 Financial Statement R&D costs (ADJ ASC 730 R&D) for the credit year. This Process Unit explains the steps LB&I taxpayers following the Directive take to calculate the required adjustments.

Required Steps 1 - 5 in this Process Unit, as explained later, give guidance in completing Appendices C and D of the Directive and optional Steps 6 – 9 provide guidance for separately identifying costs in excess of the ADJ ASC 730 R&D amount claimed on the Form 6765. Reviewing a printed copy of the Directive and the Examples of the Process (covered later in this Process Unit) will assist in understanding and completing the required appendices and providing the optional information.

LB&I taxpayers following the Directive must maintain, at a minimum, the documentation identified later in “Other Considerations” to support the Step 1 through 5 adjustments when computing their ADJ ASC 730 R&D. LB&I exam teams may request to review this documentation.

Detailed Explanation of the Process

ASC 730 Directive - Computing Qualified Research Expenses

Analysis

Taxpayers may have voluntarily attached the completed and signed Certification Statement Claiming ADJ ASC 730 Financial Statement R&D as QREs ("Certification Statement") (Appendix A of the Directive) and Appendices B, C, and D of the Directive to their federal income tax return to demonstrate their eligibility under the provisions of the Directive. If the taxpayer did not voluntarily attach these documents to the return, the audit team will verify whether the taxpayer followed or plans to follow the Directive at the beginning of the examination of the research credit. For taxpayers choosing to follow the Directive, the exam team should ask the taxpayer to provide the completed disclosure statements (Appendices A – D).

Exam teams should review the affidavit and Appendices for completeness. To verify completeness and compliance with the Directive, the exam team should ask the taxpayer to provide the required information (listed later in "Other Considerations").

Taxpayers including QREs on their Form 6765 that exceed the ADJ ASC 730 R&D amount report those costs in columns B and C of Appendix B. Taxpayers may include (at their option) additional schedules providing support for these expenditures. Information provided will aid the exam team in preparing their risk analysis of the additional QREs. Steps 6 through 9 and the examples that follow provide a suggested format for providing this information.

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

Examiners should direct questions concerning the Directive to the General Business Credits Practice Network.

Summary of Process Steps

ASC 730 Directive - Computing Qualified Research Expenses

Process Steps

Steps 1 – 5 determine the Adjusted ASC 730 Financial Statement R&D qualified research expenditures (QREs) from the Directive. Steps 6 – 9 are optional and provide additional information to help the exam team risk the remaining QREs.

Step 1	ASC 730 Research & Development Expenses
Step 2	Subtraction of All Foreign Entities' R&D Costs
Step 3	Subtractions from ASC 730 R&D, Lines 5 – 10
Step 4	R&D Wage Adjustments, Lines 13 – 17

Summary of Process Steps (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Process Steps

Steps 1 – 5 determine the Adjusted ASC 730 Financial Statement R&D qualified research expenditures (QREs) from the Directive. Steps 6 – 9 are optional and provide additional information to help examination risk the remaining QREs.

Step 5	ASC 730 QREs, Lines 19 – 22
Step 6	Wages Excluded from ADJ ASC 730 R&D
Step 7	Contract Costs Excluded from ASC 730
Step 8	Non-ASC 730 Wages and Stock Options

Summary of Process Steps (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Process Steps

Steps 1 – 5 determine the Adjusted ASC 730 Financial Statement R&D qualified research expenditures (QREs) from the Directive. Steps 6 – 9 are optional and provide additional information to help examination risk the remaining QREs. Step 10 summarizes all QREs.

Step 9	Non-ASC 730 Non-Wage Costs
Step 10	Summary of Costs – Appendix B

Step 1: ASC 730 Research & Development Expenses

ASC 730 Directive - Computing Qualified Research Expenses

Step 1

The starting point for determining the ADJ 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 Certified Audited Financial Statements are not eligible to follow the Directive.</p> <p>The Directive Appendix C, Step 1 amount only includes the expenditures the taxpayer reported as book ASC 730 R&D expenditures on the Certified Audited Financial Statements. These are the costs the taxpayer reported separately as “Research and Development” on its Income Statement in the Certified Audited Financial Statements or stated as the R&D amount in the Notes to the Certified Audited Financial Statements.</p> <p>Compare the amount on Appendix C, line 1 to the amount of R&D expenditures the taxpayer separately reported on the Certified Audited Financial Statements or the R&D amount separately stated in the Notes to the Certified Audited Financial Statements. The taxpayer should explain any differences.</p> <p>Publicly traded companies also report their R&D on the Form 10-K. This amount should be the same as the amount reported on the Certified Audited Financial Statements. If they are not the same, the taxpayer should explain any differences.</p>	<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, Appendix C - Computation of Adjusted ASC 730 Financial Statement R&D</i> (9/11/17) ▪ Form 10-K - <i>Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934</i> ▪ ASC 730 - <i>Research and Development</i>

Step 2: Subtraction of All Foreign Entities' R&D Costs

ASC 730 Directive - Computing Qualified Research Expenses

Step 2

ASC 730 includes a taxpayer's worldwide ASC 730 R&D. This step removes any foreign entities R&D from the computation.

Considerations	Resources
<p>ASC 730 R&D on Certified Audited Financial Statements might include R&D expenditures from related foreign entities. Appendix C, Step 2 of the Directive removes these expenditures.</p> <p>IRC 41 specifically excludes costs associated with research conducted outside the U.S.</p> <p>The taxpayer should remove any ASC 730 R&D amounts for any foreign entities included in its 10-K or separately stated Certified Audited Financial Statements.</p> <p>Typically for book, the taxpayer accounts for R&D activities by foreign entities separately from the U.S. entities' R&D activities.</p> <p>Step 1 minus Step 2 equals U.S. ASC 730 Financial Statement R&D.</p> <p>Generally, this is the U.S. book R&D amount that the taxpayer reported on Schedule M-3, Part III Research and Development Costs, column A. The taxpayer should explain any differences.</p>	<ul style="list-style-type: none"> ▪ IRC 41(d)(4)(F) ▪ Form 1120, Schedule M-3 - <i>Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More</i>

Step 3: Subtractions from ASC 730, Lines 5 - 10

ASC 730 Directive - Computing Qualified Research Expenses

Step 3

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

Considerations	Resources
Appendix C, Step 3 of the Directive includes lines 5 – 10. This multi-step process removes from ASC 730 book R&D those costs that IRC 174 and 41 do not allow and other costs specifically excluded in determining the ADJ ASC 730 R&D expenses. See each line instruction in the Step 3 slides that follow for specific considerations.	<ul style="list-style-type: none">▪ IRC 41▪ IRC 174

Step 3: Subtractions from ASC 730, Lines 5 – 10 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 3](#)

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

Step 3: Subtractions from ASC 730, Lines 5 – 10 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 3](#)

Considerations	Resources
<p><u>Appendix C, Step 3, Line 6 - Subtract All ASC 730 General Ledger (GL) Accounts and Amounts that are Non-wage, Non-supply, and Non-Contract Research Expenditures</u></p> <p>IRC 41(b) allows two types of expenses in calculating the research credit:</p> <ul style="list-style-type: none"> ▪ In-house research expenses, and ▪ Contract research expenses. <p>In-house research expenses consist of wages and supplies.</p> <p>IRC 41 typically limits contract research expenses to 65% of any amount the taxpayer incurs or pays to non-employee persons for qualified research. Special rules under IRC 41(b)(3)(C) and (D) apply for certain research consortia and eligible small businesses, etc.</p>	<ul style="list-style-type: none"> ▪ IRC 41(b)

Step 3: Subtractions from ASC 730, Lines 5 – 10 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 3](#)

Considerations	Resources
<p><u>Appendix C, Step 3, Line 6 - Subtract All ASC 730 General Ledger (GL) Accounts and Amounts that are Non-wage, Non-supply, and Non-Contract Research Expenditures (cont'd)</u></p> <p>This is not an all-inclusive list. The taxpayer subtracts expenses recorded in the ASC 730 Financial Statement R&D accounts that include costs not allowed under IRC 41. These costs may include the following:</p> <ul style="list-style-type: none">▪ Depreciation,▪ Amortization,▪ Shipping,▪ Training,▪ Travel,▪ General and administrative expenses,▪ Overhead,▪ Rent, or▪ All other items not eligible for section 41 QRE's.	<ul style="list-style-type: none">▪ IRC 41(b)

Step 3: Subtractions from ASC 730, Lines 5 – 10 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 3](#)

Considerations	Resources
<p><u>Appendix C, Step 3, Line 7 - Subtract All ASC 730 Costs Incurred for All Third-Party 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 ADJ ASC 730 R&D expenditures.</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 the expenditures here does not prevent the taxpayer from claiming these costs as additional QREs outside of the Directive. Additional QREs are subject to risk analysis and examination.</p>	<ul style="list-style-type: none"> ▪ IRC 41(d)(4)(H)

Step 3: Subtractions from ASC 730, Lines 5 – 10 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses



[Step 3](#)

Considerations	Resources
<p><u>Appendix C, Step 3, Line 8 - Subtract All ASC 730 Costs Incurred for All Persons Other Than Taxpayer's Employees (i.e., Third Parties)</u></p> <p>Although the taxpayer is allowed 65% (typically) of qualifying research expenditures for third-party subcontractor costs in calculating the research credit, the Directive removes the full amount of these expenditures from the ADJ ASC 730 R&D expenditures.</p> <p>Removal of the expenditures here does not prevent the taxpayer from claiming these costs as additional QREs outside of the Directive. Additional QREs are subject to risk analysis and examination.</p>	<ul style="list-style-type: none">▪ IRC 41(d)(4)(H)

Step 3: Subtractions from ASC 730, Lines 5 – 10 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 3](#)

Considerations	Resources
<p><u>Appendix C, Step 3, Line 9 - Subtract All ASC 730 Wages and Supplies for Research Performed Outside of the U.S.</u></p> <p>The taxpayer should subtract all the wages and wage-related costs (including stock options if reported in ASC 730 R&D accounts) it incurred or paid to individuals for ASC 730 research performed outside the U.S.</p> <p> CAUTION: The taxpayer should also subtract costs for any supplies used in research performed outside of the U.S.</p> <p> CAUTION: Do not include these wages in Appendix C, Step 4 on lines 13 & 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 & 17.</p>	<ul style="list-style-type: none">▪ IRC 41(d)(4)(F)

Step 3: Subtractions from ASC 730, Lines 5 – 10 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 3](#)

Considerations	Resources
<p><u>Appendix C, Step 3, Line 10 - Subtract All ASC 730 Expenses for Prototype Overhead, Patent Costs, and Severance Pay Expenditures</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&E) expenditures qualifying for a trade or business deduction under IRC 174, specifically for legal and patent expenses. R&E expenditures under IRC 174 include the taxpayer's cost of obtaining a patent and attorney's fees it expended in making and perfecting a patent application. Patent and other legal work, however, generally does not meet all the requirements of IRC 41(d).</p> <p>Typically, severance payments are not for the performance of qualified research. Costs allowed as QREs are those the taxpayer paid or incurred in connection with its trade or business and represent R&D costs in the experimental or laboratory sense to eliminate uncertainty concerning the development or improvement of a product, process, etc. Severance payments are amounts the taxpayer agreed to pay to specific individuals because they are leaving the company and did not pay as compensation for research or experimental activities as required by IRC 174(a).</p> <p>After completing all parts of Step 3, total the amounts and subtract them from U.S. ASC 730 Financial Statement R&D, i.e., line 3 on Appendix C of the Directive.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.174-2(a)(1) ▪ IRC 41(d) ▪ IRC 174(a) ▪ FAA 20131102F – Treatment of Voluntary Separation Payments as Qualified Research Expenditures Under IRC 41

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

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 of the Directive removes all remaining ASC 730 wages and stock options before adding back the W-2 Wages. The taxpayer should not include any W-2 compensation amounts relating to the subtractions in Step 2 and 3. The W-2 wages added in this step should only relate to wage costs that the taxpayer charged to U.S. ASC 730 Financial Statement Cost Centers, i.e., those cost centers it included as ASC 730 R&D expenses on the Certified Audited Financial Statements.	

Step 4: R&D Wage Adjustments, Line 13 - 17 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 4](#)

Considerations	Resources
<p><u>Appendix C, Step 4, Line 13 - Remove ASC 730 Wages Not Already Removed</u></p> <p>Book wages are typically not an accurate reflection of an employee's gross W-2 income and the Directive removes them from the computation. The taxpayer must subtract any book wages remaining in the ASC 730 Financial Statement R&D amount that it did not subtract previously. This subtraction will result in no wages remaining in the computation at this point. (The taxpayer will add back allowed W-2 wages in Step 4, lines 15 – 17 later.)</p> <p>The only wages allowed as QREs are wages identified under IRC 3401(a), which include any amount reported in the employee's gross W-2 income.</p>	<ul style="list-style-type: none">▪ IRC 3401(a)

Step 4: R&D Wage Adjustments, Line 13 - 17 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 4](#)

Considerations	Resources
<p><u>Appendix C, Step 4, Line 14 – Remove Any Remaining Stock-Based Compensation</u></p> <p>This step removes book stock options the taxpayer reported in ASC 730 accounts.</p> <p>The taxpayer does not always report stock options in ASC 730 accounts. The taxpayer must only subtract the amount reported in the ASC 730 accounts that it included in the U.S. ASC 730 Financial Statement R&D and did not previously subtract.</p> <p>The taxpayer adds back allowed taxable W-2 stock options for qualified individual contributors (QIC) and 1st level supervisor managers (both defined in the “Definitions” section of this Unit) in Step 4, lines 15 – 16 later.</p>	

Step 4: R&D Wage Adjustments, Line 13 - 17 (cont'd)

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 qualified individual contributors (QIC) 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 Appendix D of the Directive:</p> <p>The taxpayer adds back 95% of the taxable wages for only those employees:</p> <ul style="list-style-type: none"> ▪ Whose wages it did not previously exclude (i.e., contracts, work abroad, etc.), ▪ Who do not manage any other taxpayer employees, and ▪ Whose wages the taxpayer charged to U.S. ASC 730 Financial Statement Cost Centers. <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 section 3401(a) not including taxable stock options included in the W-2 Box 1 wages.</p>	<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, Appendix D Adjusted ASC 730 Financial Statement R&D Wage Detail (9/11/17)</i> ▪ IRC 3401(a)

Step 4: R&D Wage Adjustments, Line 13 - 17 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 4](#)

Considerations	Resources
<p><u>Appendix C, Step 4, Line 16 - Add Back, 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.</p> <p>From Appendix D of the Directive:</p> <p>The taxpayer adds back 95% of the taxable wages for only those employees:</p> <ul style="list-style-type: none">▪ Whose wages it did not previously exclude (i.e., contract, work abroad, etc.),▪ Who only manage QIC, and▪ Whose wages the taxpayer charged to U.S. ASC 730 Financial Statement Cost Centers. <p>The taxpayer should separately identify the amounts it 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, Line 13 - 17 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 4](#)

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

Step 4: R&D Wage Adjustments, Line 13 - 17 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 4](#)

Considerations	Resources
<p><u>Appendix C, Step 4, Line 17 – Add the W-2 Wages Allowed for Upper Level Managers (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 ADJ ASC 730 R&D amount. In this case, the taxpayer reports \$0 on Appendix C line 17.</p> <p>The taxpayer reports this non-limited amount it determines eligible as indicated in Steps 6 and 7 later. This non-limited amount is subject to risk analysis and examination.</p>	

Step 5: ASC 730 QREs, Lines 19 – 22

ASC 730 Directive - Computing Qualified Research Expenses

Step 5

These lines identify the total ADJ ASC 730 Financial Statement R&D and separately identify from this amount those expenses reported as wages, supplies and computer rental or lease costs.

Considerations	Resources
<p><u>Appendix C, Step 5, Line 19 - Equals the ADJ ASC 730 Financial Statement R&D</u></p> <p>The taxpayer determines this amount by adding Appendix C, line 11(a) (US ASC 730 Financial Statement R&D minus all Step 3 adjustments) of the Directive to Appendix C, line 18 (the net of Step 4 adjustments) of the Directive.</p> <p>Appendix C, Step 5, lines 20 – 22 identify the cost on line 19 to the specific cost category.</p> <p>From the amount reported as the ADJ ASC 730 R&D on Appendix C, line 19, identify the amount of:</p> <ul style="list-style-type: none"> ▪ Line 20 Wages – Report on Appendix B, Column A, Form 6765, line 5 or 24, Wages for Qualified Services. ▪ Line 21 Cost of Supplies – Report on Appendix B, Column A, Form 6765, line 6 or 25, Cost of Supplies. ▪ 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. 	<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, Appendix B, Reconciliation of Form 6765 QREs to Adjusted ASC 730 Financial Statement R&D</i> (9/11/17)

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

ASC 730 Directive - Computing Qualified Research Expenses

[Step 5](#)


Considerations	Resources
The 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, i.e., the ADJ ASC 730 R&D amount.	

Step 6: Wages Excluded from ADJ ASC 730 R&D

ASC 730 Directive - Computing Qualified Research Expenses

Step 6

Steps 6 – 7 are optional steps a taxpayer may take outside of the Directive that will assist the exam team in risking QREs originally reported in ASC 730 Financial Statement Cost Centers. Taxpayers who explain the nature of these costs will assist the exam team to better risk assess the QREs and determine if the issue needs examination.

Considerations	Resources
<p><u>Optional Step 6, Lines 1 – 10 in Examples of the Process Slides (Later in this Unit). Identify Wages Excluded from the ASC 730 Directive</u></p> <p>The wages reported in Step 6 include wages originally reported in U.S. ASC 730 Financial Statement Cost Centers that the taxpayer removed in calculating Step 5, the ADJ ASC 730 R&D. These include:</p> <ul style="list-style-type: none"> ▪ ULM wages and stock options (if the taxpayer chose not to limit the amount per Step 4, Line 17 earlier). <p> CAUTION: The taxpayer may not claim part of the ULM wages and stock options in Appendix D and the remaining amount in Step 6. The amount is either limited to the amount calculated in Appendix D or the amounts the taxpayer determined to qualify as IRC 41(b) expenditures reported in Step 6.</p> <ul style="list-style-type: none"> ▪ Wages are removed on Appendix C, Step 3, line 7 of the Directive for ASC 730 research performed pursuant to a contract for someone other than the taxpayer. 	<ul style="list-style-type: none"> ▪ IRC 41(b)

Step 6: Wages Excluded from ADJ ASC 730 R&D (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 6](#)

Considerations	Resources
<p><u>Optional Step 6, Lines 1 – 10 in Examples of the Process Slides (Later in This Unit). Identify Wages Excluded from the ASC 730 Directive (cont'd)</u></p> <p>When including managers' wages as QREs, the level of supervision, i.e., level 2, 3, 4, etc. refers to the organizational structure and the number of management levels a manager is above any QIC. For example, if a manager supervises 3 employees and employee #1 supervises other managers; employee #2 directly supervises QICs; and employee #3 is a QIC, then the manager in question is a Level 3 supervisor manager. The Directive defines any supervisor manager above a 1st level supervisor as an ULM.</p> <p>The taxpayer includes wages from ASC 730 contract research activities performed on behalf of the taxpayer that the taxpayer believes qualify under the IRC 41(d) four-part test on Appendix B, Column B, Form 6765, line 5 or 24 along with the managers wages as detailed on the next slide. These wages could include the wages of QIC, 1st level supervisors, or ULM. However, if the taxpayer claims ULM wages in Appendix B, Column B, Form 6765 line 5 or 24, the taxpayer cannot claim any ULM wages in Column A of Appendix B.</p> <p>Amounts reported in Appendix B, Column B, Form 6765, line 5 or 24 should only include W-2 wages the taxpayer paid for qualified services performed in the U.S.</p>	<ul style="list-style-type: none"> ▪ Audit Techniques Guide - <i>Credit for Increasing Research Activities (i.e. Research Tax Credit)</i> ▪ IRC 41(d)

Step 6: Wages Excluded from ADJ ASC 730 R&D (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 6](#)

Considerations	Resources
<p><u>Optional Step 6, Lines 1 – 10 in Examples of the Process Slides (Later in This Unit). Identify Wages Excluded from the ASC 730 Directive (cont'd)</u></p> <p>The following is a sample of how to breakdown supervisor manager wages not included in the ADJ ASC 730 R&D, but originally reported in ASC 730 R&D accounts.</p> <ul style="list-style-type: none">▪ Identify the amount of ASC 730 base W-2 wages for qualified services performed in the United States by Level 2, 3, and 4 supervisor managers.▪ Identify the amount of ASC 730 W-2 stock options for qualified services performed in the United States by Level 2, 3, and 4 supervisor managers.▪ Identify the amount of ASC 730 base W-2 wages for qualified services performed in the United States by Level 5 and 6 supervisor managers.▪ Identify the amount of ASC 730 W-2 stock options for qualified services performed in the United States by Level 5 and 6 supervisor managers.▪ Identify the amount of ASC 730 base W-2 wages for qualified services performed in the United States by Level 7 and above supervisor managers.▪ Identify the amount of ASC 730 W-2 stock options for qualified services performed in the United States by Level 7 and above supervisor managers.	

Step 6: Wages Excluded from ADJ ASC 730 R&D (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 6](#)

Considerations	Resources
<p><u>Optional Step 6, Lines 1 – 10 in Examples of the Process Slides (Later in This Unit). Identify Wages Excluded from the ASC 730 Directive (cont'd)</u></p> <p>Combine and report the wages from the previous slide and the wages from Step 7, line 11 below on Appendix B, Column B, Form 6765, line 5 or 24. These are the QIC and 1st level supervisor managers' wages the taxpayer originally reported in ASC 730 accounts and it removed in Appendix C, Step 3, line 7 pursuant to services performed under a contract with a third party. The taxpayer determined these wages are for non-funded research and qualify as QREs.</p>	

Step 7: Contract Costs Excluded from ASC 730

ASC 730 Directive - Computing Qualified Research Expenses

Step 7

This optional step, Lines 10a – 13a in the Example of the Process, covers contract costs excluded from ASC 730. This step identifies ASC 730 contract costs removed from Appendix C of the Directive that the taxpayer identified as QREs.

Considerations	Resources
<p><u>Step 7 – Lines 10a – 13a – Examples of the Process Slides (Later in This Unit)</u></p> <p>From the total amount of wages reported in Step 6, identify on line 10(a) those ULM wages that the taxpayer paid or incurred to perform as part of an agreement(s) with third parties.</p> <p>For lines 11 – 13a, the taxpayer must separately identify costs as wages, supplies, and contract labor it included in the U.S. ASC 730 Certified Audited Financial Statement R&D amount related to contracts that the taxpayer removed on Appendix C, Step 3, lines 7 and 8. The expenses included here are for contracts in which the taxpayer either performed the research on behalf of someone else or a third-party contractor who conducted research on behalf of the taxpayer where the taxpayer believes the costs qualify under IRC 41(d) and the four-part test. In either situation, only include costs for those services performed in the U.S.</p> <p>Enter the amount of QIC or 1st level supervisor managers' wages on line 11 that the taxpayer paid or incurred to perform services to meet the terms of the agreements/contracts with third parties. Report this amount combined with the amount on line 10 above on line 11(a) and on Appendix B, Column B, Form 6765, line 5 or 24.</p>	<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>

Step 7: Contract Costs Excluded from ASC 730 (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 7](#)

Considerations	Resources
<p><u>Step 7 – Lines 10a – 13a – Examples of the Process Slides (Later in This Unit) (cont'd)</u></p> <p>Enter the amount of supplies QREs on line 12 that the taxpayer paid or incurred in order for the taxpayer to perform services to meet the terms of agreements/contracts with third parties. The taxpayer must also report this amount on Appendix B, Column B, Form 6765, line 6 or 25.</p> <p>Enter the applicable percentage (typically 65%) of contract research QREs on line 13 that the taxpayer:</p> <ul style="list-style-type: none"> ▪ Paid or incurred for the performance of qualifying contract research activities where the taxpayer either performed the research on behalf of someone else or a third-party contractor conducted research on behalf of the taxpayer, and ▪ Recorded as contract research costs under ASC 730 R&D. <p>Report this amount on line 13 and on Appendix B, Column B, Form 6765, line 8 or 27.</p> <p>Enter on line 13(a) the amount of contract research expenses from line 13 above that the taxpayer paid or incurred to perform services to meet the terms of agreements/contracts with other third parties. (In this situation, the taxpayer is performing research services for third parties).</p>	<ul style="list-style-type: none"> ▪ IRC 41(d)(F)

Step 8: Non-ASC 730 Wages and Stock Options

ASC 730 Directive - Computing Qualified Research Expenses

Step 8

Steps 8 and 9 are optional steps to identify and explain QREs reported outside of ASC 730 for book. Taxpayers who identify the source of the QREs and whether performed pursuant to a contract allows the exam team to better risk the costs.

Considerations	Resources
<p>The amounts reported in Steps 8 and 9 are costs not included in ASC 730 R&D accounts, and therefore are not part of the amount the taxpayer reported as R&D on the Certified Audited Financial Statements.</p> <p>When the taxpayer provides any additional information regarding the source or characterization of these costs, it allows the exam team to efficiently determine the audit scope for the research credit issue.</p> <p>Step 8 identifies and categorizes the amount of wages reported in Appendix B, Column C, Form 6765 line 5 or 24.</p>	

Step 8: Non-ASC 730 Wages and Stock Options (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

[Step 8](#)

Considerations	Resources
<p><u>Step 8 – Lines 14 – 26 – Examples of the Process Slides (Later in This Unit)</u></p> <p>For accounts reported outside of ASC 730, only include those in-house wages the taxpayer paid or incurred for qualifying research services (explained in the Audit Technique Guide – Research Tax Credit Chapter 4 (ATG-RTC Ch. 4)) in conducting qualified research activities in the U.S. meeting the IRC 41(d) four-part test (also in ATG-RTC Ch. 4).</p> <p>Identify separately base W-2 wages and stock options for:</p> <ul style="list-style-type: none"> ▪ Employees directly performing qualified research activities, ▪ Employees directly supporting qualified research activities, and ▪ Management employees directly supervising employees performing qualified research activities. <p>Identify separately the base W-2 wages and stock options the taxpayer paid to ULM involved in providing qualifying research services.</p> <p>For each of the categories above, separately identify the wages and stock options the taxpayer paid or incurred to perform research activities to meet the terms of a contract(s) with third parties on lines 16a, 19a, 22a and 25a of the Examples of the Process later in the unit.</p>	<ul style="list-style-type: none"> ▪ IRC 41(b)(2) ▪ Audit Techniques Guide - <i>Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC 41</i>

Step 9: Non-ASC 730 Non-Wage Costs

ASC 730 Directive - Computing Qualified Research Expenses

Step 9

For Step 9, the taxpayer has the option to identify the QREs from accounts outside of ASC 730 Financial Statement R&D reported on Appendix B, Column C as explained below.

Considerations	Resources
<p>Identify the following costs the taxpayer incurred in performing qualified research activities (ATG-RTC Ch.4) per Example of the Process on lines 27 through 29a.</p> <p>Identify the supplies the taxpayer used in the conduct of qualified research activities. Report this amount on line 27 in the Example of the Process and on Appendix B, Column C, Form 6765, line 6 or 25.</p> <p>Identify the rental or lease costs of computers the taxpayer used in qualified research activities. Report this amount on, line 28 in the Example of the Process and on Appendix B, Column C, Form 6765, line 7 or 26.</p> <p>Identify the amount of contract research expenses the taxpayer performed in the U.S. Multiply this amount by the 65% (the typical applicable percentage) and report the figure on line 29 in the Example of the Process and on Appendix B, Column C, Form 6765, line 8 or 27.</p> <p>For each of the cost categories above, separately identify (per lines 27a, 28a and 29a in the Example of the Process), the amounts the taxpayer paid or incurred to perform activities to meet the terms of a contract(s) with third parties.</p>	<ul style="list-style-type: none"> ▪ Audit Techniques Guide - <i>Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC 41</i>

Step 10: Summary of Costs - Appendix B

ASC 730 Directive - Computing Qualified Research Expenses

Step 10

This step identifies where the taxpayer reports QREs from Steps 1 – 9 on Appendix B.

Considerations	Resources
<ul style="list-style-type: none"> ▪ From Step 5, report the wages from Appendix C, Line 20 on Appendix B, Column A, Form 6765, line 5 or 24. ▪ From Step 5, report the supplies from Line 21 on Appendix B, Column A, Form 6765, line 6 or 25. ▪ From Step 5, report the rental or lease costs of computers from line 22 on Appendix B, Column A, Form 6765, line 7 or 26. ▪ From Step 6, report the Upper Level Manager Wages on Appendix B, Column B, Form 6765, Line 5 or 24. ▪ From Step 7, report the costs from lines 11, 12 & 13 on the applicable lines of Appendix B, Column B. ▪ From Step 8, report the wages on Appendix B, Column C, Form 6765, line 5 or 24. ▪ From Step 9, report the supplies on Appendix B, Column C, Form 6765, line 6 or 25 ▪ From Step 9, report the rental or lease of computers on Appendix B, Column C, Form 6765, line 7 or 26. ▪ From Step 9, report the contract labor costs on Appendix B, Column C, Form 6765, line 8 or 27. <p>QREs reported in Columns B and C of Appendix B are subject to risk analysis and examination.</p>	<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, Appendix B (9/11/17)</i>

Exceptions

ASC 730 Directive - Computing Qualified Research Expenses

Description

Taxpayers not following U.S. GAAP for book purposes and not having Certified Audited Financial Statements are ineligible to participate in the Directive.

Taxpayers following the Directive must maintain their books following U.S. GAAP. By following U.S. GAAP, taxpayers follow the policies and procedures established for ASC 730 Research and Development. ASC 730 allows specific types of activities with many similarities to those activities identified under IRC 174 and IRC 41 eligible for the credit. Licensed third parties performing certified audits provides assurance that taxpayers are either complying or not complying with the rules under ASC 730. Taxpayers without Certified Financial Statement Audits are unable to provide assurance to the exam team that the research activities conducted are similar to the activities under IRC 41 and 174.

Definitions

ASC 730 Directive - Computing Qualified Research Expenses

Description

- Adjusted ASC 730 Financial Statement R&D/ADJ ASC 730 R&D - ASC 730 Financial Statement R&D adjusted pursuant to the methodology shown in Appendix C of the Directive and the definitions contained here and in Appendix E of the Directive.
- 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. The overall subtopic in ASC 730 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.
- ASC 730 Financial Statement R&D - Research and development costs currently expensed pursuant to ASC 730 for U.S. GAAP purposes and the taxpayer shows the amount expensed as a line item on a taxpayer’s income statement included in its Certified Audited Financial Statements or the taxpayer shows the amount expensed separately stated in the note to its Certified Audited Financial Statements.
- ASC 730 R&D GL Accounts - The General Ledger (GL) Accounts which make up ASC 730 Financial Statement R&D.
- Base W-2 Wages - “Wages” as defined by section 3401(a) not including taxable stock options included in the W-2 Box 1 wages.

Definitions (cont'd)

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.

Definitions (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Description

- 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).
- Credit Year - The taxable year for which the Research Credit is being determined.
- Financial Statement - A financial statement that is 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 can be directly relied on for the purposes for which it was given or provided.
- 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 and the taxpayer does not retain a substantial right in the research. See section 1.41-4A(d).

Definitions (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Description

- 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.
- Prototype (also 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.

Definitions (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Description

- 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)(4).
- Taxpayer - Person electing to follow this Directive.
- 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/or 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 (e.g. 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 - ASC 730 Financial Statement R&D adjusted by removal of all ASC 730 GL Accounts relating to Foreign Entities.

Definitions (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Description

- 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.
- U.S. GAAP - U.S. 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).
- 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.

Examples of the Process

ASC 730 Directive - Computing Qualified Research Expenses

Description

The Directive provides a template (Appendices C and D) the taxpayer must follow in determining their ADJ ASC 730 R&D. It also provides Appendix B as a reconciliation of QREs to report on Form 6765 - *Credit for Increasing Research Activities*. However, the Directive provides no additional guidance regarding information the taxpayer can provide to assist the exam team in efficiently determining the scope of examination related to the QREs claimed in Columns B and C of Appendix B. The Example of the Process, Steps 6 – 10 discussed previously provides options for the taxpayer to follow in identifying and categorizing the QREs reported in Columns B and C of Appendix B.

Lines 1 – 13a give the taxpayer the option to further identify and categorize those costs removed from ASC 730 as required in Appendix C of the Directive. The taxpayer reports the removed costs meeting the IRC 41(d) four-part test on Column B of the Directive. These costs should only include ULM wages (if the taxpayer reported \$0 on Appendix C, line 17) and costs associated with contracts. These lines relate to Step 6 and 7 in this Process Unit

Lines 14 – 29a are costs the taxpayer reports outside of ASC 730 accounts (Steps 8 and 9 of this Process Unit). Report these costs in Appendix B, Column C.

Examples of the Process (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Description

Step 6 - Taxpayers determining that more than 10% of their ULM (see Definitions) wages and stock options are eligible QREs can follow lines 1 – 10 below to assist the exam team in determining the scope of examination. The source of these QREs are from the ASC 730 W-2 wages (base wages and stock options) removed from the ADJ ASC 730 R&D computation (Appendices C and D of the Directive) for the ULM Limit. The level of supervision, i.e. level 2, 3, 4, etc. refers to the organizational structure and the number of management levels a manager is above any QIC, e.g., Level 4 Manager is manager who manages 3 levels of managers, i.e., 1st level, 2nd level and 3rd level managers.

Line #	Description – ASC 730 Wages	Amount	Subtotal
1	Level 2, 3, & 4 Managers' Base W-2 Wages.	300,000	
2	Level 2, 3, & 4 Managers' Stock Options.	100,000	
3	Total W-2 Wages Level 2, 3, and 4 Managers. Add lines 1 and 2.		400,000
4	Level 5 and 6 Managers' Base W-2 Wages.	300,000	
5	Level 5 and 6 Managers' Stock Options.	100,000	
6	Total W-2 Wages Level 5 and 6 Managers. Add lines 4 and 5.		400,000
7	Level 7 and 8 Managers' Base W-2 Wages.	1,500,000	
8	Level 7 and 8 Managers' Stock Options.	500,000	
9	Total W-2 Wages Level 7 and 8 Managers. Add lines 7 and 8.		2,000,000
10	Total Level 2 and above management wages from ASC 730 accounts not included in ADJ ASC 730 R&D. Add lines 3, 6, and 9.		2,800,000

Examples of the Process (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Description

Step 7 - The source for QREs identified in lines 10(a) – 13(a) are ASC 730 contract research expenditures removed from Appendix C, lines 7 & 8.

Line #	Description – ASC 730 Contract Costs	Amount	Subtotal
10a	Enter the amount of Upper Level Management wages from line 10, where the taxpayer paid or incurred the wages to perform services to meet the terms of agreements/contracts with third parties.	500,000	
11	Enter the amount of QIC or 1 st Level Supervisor Managers wages that the taxpayer paid or incurred to perform services to meet the terms of the agreements/contracts with third parties.	300,000	
11a	Add lines 10 and 11. Record this amount on Appendix B, Column B, Form 6765, line 5 or 24.		3,100,000
12	Enter the amount of supply QREs that the taxpayer paid or incurred to perform services to meet the terms of agreements/contracts with third parties. Record this amount on Appendix B, Column B, Form 6765, line 6 or 25.		250,000

Examples of the Process (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Description

Step 7 (cont'd)

Line #	Description – ASC 730 Contract Costs	Amount	Subtotal
13	Enter the amount of contract research QREs based on the applicable percentage of Contract Research expense paid or incurred for qualifying research activities recorded in ASC 730 R&D Cost Centers. Record this amount on Appendix B, Column B, Form 6765, line 8 or 27.		250,000
13a	From the amount of Contract Research expenses claimed on line 13, above, identify how much of the contract research expenses the taxpayer paid or incurred to perform services to meet the terms of agreements/contracts with other third parties.	50,000	

Examples of the Process (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Description

Step 8 - The expenditures identified in lines 14– 29 are for costs incurred outside of the ASC 730 Costs centers and the Directive did not include in the ADJ ASC 730 R&D amount. Costs outside of the ADJ ASC 730 R&D amount and reported on the Form 6765 are subject to risk analysis and examination. The taxpayer should separate the wages in lines 14 – 26 below into different categories based on IRC 41(b). This optional information will help in determining the scope of an examination of the research credit. The exam team determines the scope of an audit based on the taxpayer's facts and circumstances.

Line #	Description – Non-ASC 730 Wages	Amount	Subtotal
14	Employees engaging in qualified research (non-management) Base W-2 Wages.	300,000	
15	Employees engaging in qualified research (non-management) Stock Options.	100,000	
16	Total Wages. Add lines 14 & 15.		400,000
16a	Amount of wages claimed on line 16 above where the taxpayer incurred the wages to meet the terms of the agreement(s) or contracts with third parties.	100,000	
17	Employees providing direct support of qualifying research (non-management) Base W-2 Wages.	100,000	
18	Employees providing direct support of qualifying research (non-management) Stock Options.	0	
19	Total Direct Support Wages. Add lines 17 and 18.		100,000
19a	Amount of wages claimed on line 19 above where the taxpayer incurred the wages to meet the terms of the agreement(s) or contracts with third parties.	100,000	

Examples of the Process (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Description

Step 8 (cont'd) - Although the taxpayer does not report the amounts identified on lines 16a, 19a, 22a and 25a on the Appendix B, providing this information will assist the exam team in determining the scope of the examination for QREs outside of the ADJ ASC 730 R&D. Level 2 and above managers refers to organizational charts where the manager supervises at least one employee who supervises other employees.

Line #	Description – Non-ASC 730 Wages	Amount	Subtotal
20	Level 1 Supervisors' Base W-2 Wages.	350,000	
21	Level 1 Supervisors' Stock Options.	150,000	
22	Total Level 1 Supervisors' Wages. Add lines 20 and 21.		500,000
22a	Amount of wages claimed on line 22 above where the taxpayer incurred the wages to meet the terms of the agreement(s) or contracts with third parties.	100,000	
23	Level 2 and above Managers' Base W-2 Wages.	1,000,000	
24	Level 2 and above Managers' Stock Options.	1,000,000	
25	Level 2 and above Managers' Wages. Add lines 23 and 24.		2,000,000
25a	Amount of wages claimed on line 25 above where the taxpayer incurred the wages to meet the terms of the agreement(s) or contracts with third parties.	500,000	
26	Add the amounts from lines 16, 19, 22, & 25 and put it on Appendix B, Column C, Form 6765, line 5 or 24.		3,000,000

Examples of the Process (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Description

Step 9 - Although the taxpayer does not report lines 27a, 28a & 29a on Appendix B, Column C, they will help the exam team determine the scope of the exam.

Line #	Description – Non-ASC 730 Supplies	Amount	Subtotal
27	Identify the amount of supply expense claimed as QREs not included in ADJ ASC 730 R&D. Report this amount here and on Appendix B, Column C, Form 6765, line 6 or 25.		100,000
27a	Of the amount on line 27 above, identify what amount the taxpayer incurred to meet the terms of agreement(s) or contracts with third parties.	30,000	

Line #	Description – Non-ASC 730 Rental/Lease Expense Computer Equipment	Amount	Subtotal
28	Identify the amount of rental or lease expense of computers claimed as QREs not included in ADJ ASC 730 R&D. Report the amount here and on Appendix B, Column C, Form 6765, line 7 or 26.		25,000
28a	Of the amount on line 28 above, identify what amount the taxpayer incurred to meet the terms of agreement(s) or contracts with third parties.	5,000	

Examples of the Process (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses

Description

Step 9 (cont'd).

Line #	Description – Non-ASC 730 Contract Labor	Amount	Subtotal
29	Identify the amount of applicable percentage of contract research expenses claimed as QREs not included in ADJ ASC 730 R&D. Report the amount here and on Appendix B, Column C Form 6765, line 8 or 27.		300,000
29a	Of the amount on line 29 above, identify what amount the taxpayer incurred to meet the terms of agreement(s) or contracts with third parties.	50,000	

Other Considerations / Impact to Audit

ASC 730 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 the Directive. The authorized individual certifies under penalty of perjury that for the applicable taxable year:</p> <ul style="list-style-type: none"> ▪ The taxpayer computed the ADJ ASC 730 R&D in accordance with the definitions and methodology set forth in the Directive, and ▪ 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. <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"> ▪ <i>LB&I Directive - 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 (9/11/17)</i>
<p>The taxpayer must retain and make available upon request the underlying books and records ("documentation") that support the amounts reported on Directive Appendices B, C and D, inclusive. The Director of Field Operations or his/her delegate can determine a taxpayer is ineligible to apply the Directive when the taxpayer fails to properly retain and timely submit the requested documentation.</p>	

Other Considerations / Impact to Audit (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses	
Considerations	Resources
<p>Taxpayers must retain and make available upon request, documentation relating to Appendices C and D which include, but is not limited to:</p> <ul style="list-style-type: none"> ▪ Certified Audited Financial Statement for the credit year including auditor's certifying opinion, ▪ Taxpayer's Chart of Accounts, ▪ List of U.S. ASC 730 Financial Statement Cost Centers that make up the ASC 730 Financial Statement R&D amount shown in Step 1 of Appendix C, ▪ All ASC 730 R&D GL Accounts with account balance details that make up the ASC 730 Financial Statement R&D amount shown in Step 1 of Appendix C, ▪ List of ASC 730 R&D GL Accounts with account balances that make up the adjustments in Steps 2 through 4 of Appendix C, ▪ Taxpayer's organization chart showing employees and levels of management for the Credit Year, ▪ Executed contracts pursuant to which the taxpayer is performing ASC 730 research to comply with the terms of the contract, ▪ 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.), and ▪ List of employees with their respective W-2 wage amounts the taxpayer claimed as additions to U.S. ASC 730 Financial Statement R&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. 	<ul style="list-style-type: none"> ▪ <i>LB&I Directive - 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 (9/11/17)</i>

Other Considerations / Impact to Audit (cont'd)

ASC 730 Directive - Computing Qualified Research Expenses	
Considerations	Resources
<p>The guidelines under the Directive limit the examination scope of the expenditures calculated in Steps 1 through 5. However, this does not prevent the taxpayer from reporting other expenditures on the Form 6765 - <i>Credit for Increasing Research Activities</i>. The benefit of the Directive only applies to the amount determined as the ADJ ASC 730 Financial Statement R&D QRE amounts.</p>	<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 (9/11/17)</i>
<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 ADJ ASC 730 R&D QRE amount is subject to risk assessment. 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>Exam teams receiving assigned returns where the taxpayer follows the Directive should use:</p> <ul style="list-style-type: none"> ▪ Project Code 1511 – LB&I Research and Experimentation Credit IIR and ▪ Tracking Code 6750 – LB&I Directive – Credit for Increasing Research Activities under IRC 41. 	
<p>LB&I examiners will not challenge ADJ ASC 730 R&D QREs for the credit year if the taxpayer properly calculates these QREs following Steps 1 through 5 of this Process Unit/Directive and are certified (as required by the Directive).</p>	

Index of Referenced Resources

ASC 730 Directive - Computing Qualified Research Expenses

IRC 41

IRC 41(b)

IRC 41(d)(4)

IRC 174

IRC 174(a)

IRC 3401

Treas. Reg. 1.41

Treas. Reg. 1.174

ASC 730

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

FAA 20131102F – Treatment of Voluntary Separation Payments as Qualified Research Expenditures Under IRC 41

Form 1120, Schedule M-3 - *Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More*

Form 6765 - *Credit for Increasing Research Activities*

Form 10-K - *Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*

LB&I Directive - *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 (9/11/17)*

Glossary of Terms and Acronyms

Term/Acronym	Definition
ADJ ASC 730 R&D	Adjusted ASC 730 Financial Statement Research and Development
ASC	Accounting Standards Codification
ATG-RTC	Audit Technique Guide - Research Tax Credit
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principle
GL	General Ledger
IRC	Internal Revenue Code
LB&I	Large Business & International
QIC	Qualified Individual Contributor
QREs	Qualified Research Expenditures
R&D	Research and Development
R&E	Research or Experimental
ULM	Upper Level Manager

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
41.00-00	<i>ASC 730 Research and Development - How It Relates to IRC 41 and 174</i>	GBC/C/272_07_01-01