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**The Financial Services Industry
and the Research and Development Tax Credit**

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THE FINANCIAL SERVICES INDUSTRY AND THE RESEARCH AND DEVELOPMENT TAX CREDIT

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Although the R&D tax credit provides substantial benefits, the financial services industry continues to be hesitant to take advantage of the credit for several reasons.

The financial services industry is an essential component of the U.S. economy that provides liquidity to companies and individuals, is responsible for safeguarding and investing assets, and offers insurance to allow businesses to take on risks in the marketplace. Innovation has long been considered a cornerstone of growth for the industry, leading to new products and processes, including new trading applications, new online and mobile banking functionality, and automation of previously manual processes. In addition, most firms in the industry have begun to focus on cyber security, given the rise in detected incidents.

Many businesses within the financial services industry, including banking and capital markets, asset management, and insurance, routinely develop new or improved proprietary trading systems or valuation models; experiment with new software methodologies for im-

proved security or stability; modify algorithms; develop novel algorithms for investment funds; and implement new coding techniques to improve processing volumes or speeds. Numerous activities associated with these initiatives will qualify for the research and development (R&D) tax credit, often an overlooked and misunderstood opportunity for taxpayers.

This article is aimed at taxpayers who are involved in qualified research activities and want to minimize their tax liability. It will discuss the definition, history, and recent developments of the R&D credit. Also, it describes examples of product and process improvements within the financial services industry that satisfy IRS guidelines for R&D credits.

Introduction: What is the R&D tax credit?

The R&D credit, also known as the research and experimentation (R&E) credit, was first introduced by Congress in 1981. The credit's purpose is to reward U.S. firms for increasing spending on research and development within the U.S. The R&D credit is available to businesses that uncover new, improved, or technologically advanced products, processes, principles, methodologies, or materials. In addition to "revolutionary" activities, the credit may be available if a firm has performed "evolu-

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tionary” activities such as investing time, money, and resources toward improving its products and processes. Correctly calculating the R&D credit is critical, because the credit can be used to lower a firm’s effective tax rate and generate increased cash flow. Also, the credit can serve to further catalyze R&D capabilities and innovation.

The R&D credit continues to be underutilized by qualified firms and their business management teams, particularly within the financial services industry. Reasons include a misunderstanding of qualification and documentation requirements for federal and state credits; fear of triggering an IRS audit in the current or prior year tax returns; and the perception that the credits are limited in scope or fleeting in nature due to their persistently short renewal periods.

How does the R&D credit work?

The R&D credit is available to taxpayers who incur incremental expenses for qualified research activities (QRAs) conducted within the U.S. The credit is comprised primarily of the following qualified research expenses (QREs):

1. Internal wages paid to employees for qualified services.¹
2. Supplies used and consumed in the R&D process.²
3. Contract research expenses (when someone other than an employee of the taxpayer performs a QRA on behalf of the taxpayer, regardless of the success of the research). Many times supervisory efforts of senior scientists and owners are missed because those expenses do not reside in the traditional cost buckets.³
4. Basic research payments made to qualified educational institutions and various scientific research organizations.⁴

For an activity to qualify for the research credit, the taxpayer must show that it meets the following four tests:⁵

1. The activities must rely on a hard science, such as engineering, computer science, biological science, or physical science.
2. The activities must relate to the development of new or improved functionality, performance, reliability, or quality features of a structure or component of a structure, including product or process designs that a firm develops for its clients.
3. Technological uncertainty must exist at the outset of the activities. Uncertainty exists if the information available at the outset of the proj-

ect does not establish the capability or methodology for developing or improving the business component, or the appropriate design of the business component.

4. A process of experimentation (e.g., an iterative testing process) must be conducted to eliminate the technological uncertainty. This includes assessing a design through modeling or computational analysis.

In addition to these four tests, if development is conducted related to internal use software (IUS), there are an additional three tests that must be satisfied. IUS is software that is not intended to be leased, licensed, or sold to a third party. The additional three tests are:

1. The software must be innovative. (It results in a reduction in cost or an improvement in speed that is substantial and economically significant.)
2. Developing the software involves significant economic risk. (The taxpayer commits substantial resources to software development and, due to technical risk, there is substantial uncertainty it will recover the resources in a reasonable period.)
3. The software is not commercially available. (The taxpayer cannot purchase, lease or license, and use the software for the intended purpose without modifications that satisfy the first two requirements.)

Once it is established that the activities qualify, a thorough analysis must be performed to determine that the taxpayer has assumed the financial risk associated with,⁶ and will have substantial rights to,⁷ the products or processes that are developed through the work completed. The next step is to develop a methodology for identifying, quantifying, and documenting project costs that may be eligible for the R&D credit. Costs that qualify for the credit include wages of employees involved in developing new or improved products or processes, supplies used or consumed during the research

¹ Wages include amounts considered to be wages for federal income tax withholding purposes. Sections 41(b)(2)(D)(i) and 3401(a).

² Supplies are any tangible property other than land or improvements to land, and property subject to depreciation. Section 41(b)(2)(C).

³ Section 41(b)(3).

⁴ Section 41(b)(3)(C).

⁵ Section 41(d)(1).

⁶ Reg. 1.41-2(e)(2).

⁷ Reg. 1.41-2(e)(3); see also *Lockheed Martin Corporation*, 210 F.3d 1366, 85 AFTR2d 2000-1495 (CA F.C., 2000).

process, and 65% of fees paid to outside contractors who provide qualifying R&D services on the taxpayer's behalf.

Determining the true cost of R&D is often difficult because few firms have a project accounting system that captures many of the costs for support provided by the various personnel who collaborate on R&D. The typical project tracking system may not include contractor fees, direct support costs, and salaries of high-level personnel who participate in the research effort.

Appropriate documentation may require changes to a firm's recordkeeping processes because the burden of proof regarding all R&D expenses claimed is on the taxpayer. The firm must maintain documentation to illustrate the nexus between QREs and QRAs. According to the IRS Audit Techniques Guide for the R&D credit, the documentation must be contemporaneous, meaning that it was created in the ordinary course of conducting the QRAs. Furthermore, a careful analysis should take place to evaluate whether expenses associated with eligible activities performed in the firm outside of the R&D department may have been missed and can be included in the R&D credit calculation. This is accomplished by interviewing personnel directly involved in R&D or those who are in support or supervision of R&D efforts.

Recent developments

The R&D credit has been evolving since it was originally enacted in 1981 and enjoys broad bipartisan political support. Although the credit has expired and been retroactively reinstated numerous times, it is more likely to be made permanent than it is to go by the wayside. Qualified firms doing a cost-benefit analysis should consider that most states also offer a R&D tax credit, which requires similar documentation to the federal credit, thereby significantly increasing the benefits side of the equation. Some of these state credits are refundable (e.g., Virginia).

Recently, the American Taxpayer Relief Act of 2012 (Act), which was signed into law on 1/2/13, included two significant modifications to the R&D credit. First, the Act modified the treatment of acquisitions and dispositions. Under the Act, a taxpayer acquiring a trade or business prorates the target's QRE gross receipts, and related base-period effect based on the number of days from the time of acquisition through the end of the controlled group's

tax year. The Act provides for similar treatment in the event of the disposition of a trade or business. Second, the Act modified the method by which the R&D credit is allocated to the members of a controlled group of corporations (any two or more corporations connected through a common stock ownership percentage of at least 80%). Prior to the Act, there were two different allocation methods based on the ratio of the stand-alone credit to the group credit, and the ratio of stand-alone QRE to group QRE. The proper method to use depended on the amount of the group credit as compared to the sum of the stand-alone credits. Under the Act, regardless of the amount of the group credit as compared to the sum of the stand-alone credits, the R&D credit allocable to the members of a controlled group is the proportionate basis to its share of the aggregate of the QRE.

Additionally, in September 2013, the Treasury Department and IRS proposed taxpayer-friendly regulations that would amend the Section 174 definition of "research and experimentation" (R&D) expenditures. Under the guidance provided in Section 174, taxpayers are allowed to either currently deduct R&D expenditures as they are paid or incurred, or treat them as deferred expenses amortizable over a period of not less than 60 months. The existing regulations provide that a determination of whether costs qualify as R&D expenditures depends on whether the costs are required R&D expenses critical to activities intended to discover information that would eliminate uncertainty. The IRS is now proposing that if expenditures do qualify as R&D expenditures during the course of the development effort, it will no longer matter if the resulting product is ultimately sold or is used in the taxpayer's trade or business.

In another positive development, the IRS announced in August 2012 that it will no longer use the "tiered issue process" to determine exam priorities and address corporate tax issues, freeing the R&D credit from its historical designation as a Tier I audit issue. This designation has long discouraged firms from using the credit for fear of increased audit scrutiny. The level of compliance risk should now be less of a concern for qualified firms wanting to pursue R&D credits. Additionally, a taxpayer can submit a pre-filing agreement application with the IRS to request consideration of an R&D credit issue before a return is filed, and thus, resolve potential disputes and contro-

versy earlier in the examination process. The program's effect is to reduce the cost and burden associated with the post-filing examination, to provide a desired level of certainty regarding a transaction, and to make better use of taxpayer and IRS resources. Detailed information about the pre-filing agreement application process can be found in Rev. Proc. 2001-22.⁸

Government officials, knowing that innovation is critical to any firm's success and to overall U.S. economic growth, have legislated alternative calculation options over the years to encourage U.S. firms to invest in research and development and to make the credit more valuable and obtainable. The Alternative Simplified Credit (ASC) is the most recent example. The ASC removes complications inherent in prior calculation methods and significantly eases the R&D credit's documentation burden. Legislators have also expanded the definition of what qualifies as R&D to include "process improvements," which makes the credit available to many previously excluded industries such as energy exploration, software development, and financial services.

On 1/16/15, the Treasury and IRS released proposed regulations (REG-153656-03) regarding IUS expenditures as related to the R&D credit. The proposed regulations contain several important changes related to claiming the R&D credit for IUS expenditures. The IRS recognizes the changing world of technology in new guidance that brings up to date the definition of IUS so that more consumer-facing software will be eligible for the R&D credit.

First, the regulations clarify the definition of IUS. According to the regulations, IUS is software developed by the taxpayer for general and administrative functions. These general and administrative functions are limited to human resource management, financial management, and support services. Further, software developed by the taxpayer that enables the taxpayer to interact with third parties, allows third parties to initiate functions or review data on the taxpayer's system, or is otherwise commercially sold, leased, licensed, or marketed to third parties is not classified as IUS. This distinction is important because software developed by the taxpayer that is considered to be IUS must meet the three-part, high-threshold-of-innovation test in addition to the four-part test to qualify for the R&D credit (see above).

Second, to meet the high threshold test, the developed IUS must be innovative, must in-

volve significant economic risk, and must not be commercially available to the taxpayer. The proposed regulations clarify that internally developed software is considered innovative if the development would result in a substantial and economically significant reduction in cost, improvement in speed, or other measurable improvement. The regulations also reiterate that significant economic risk exists only if the taxpayer commits substantial resources to the development and the likelihood that such resources will be recovered within a reasonable period is substantially uncertain. In defining substantial uncertainty, the proposed regulations note that the uncertainty must relate to the capability or methodology, but not the appropriate design of the business component to create a higher threshold for eligibility than Congress originally intended for IUS.

Additionally, the regulations provide that dual-purpose software developed for both internal and third-party use is presumed to be IUS. However, the portion of qualifying expenditures related to third-party use may still be eligible for the R&D credit. The regulations provide a safe harbor for expenditures related to the development of such dual-purpose software. According to the regulations, a qualifying taxpayer may include 25% of the qualifying research expenditures related to the dual-purpose software in the calculation of the R&D credit. This safe harbor applies only if the taxpayer anticipates that at least 10% of the dual-purpose software will be used for third-party purposes.

Finally, the proposed regulations provide examples that illustrate their applicability to computer software. Specifically, the examples address the process-of-experimentation and high-threshold-of-innovation tests as well as the application of the new dual function computer software rules.

Financial services industry examples of qualifying and nonqualifying R&D activities

Qualifying R&D activities as they apply to the financial services industry generally fall within four general buckets: (1) new product development; (2) incremental product development; (3) new process development; and (4) incremental process development. (See Exhibit 1).⁹

⁸ 2001-1 CB 745.

⁹ See, Holtzman, "Secret Ingredient For Keeping Innovation Fresh—The R&D Tax Credit," 94 PTS 11, (January 2015).

The R&D credit continues to be underused by qualified firms and their business management teams, particularly within the financial services industry.

EXHIBIT 1

Four types of R&D tax credit qualifying research activities

<p>New Product Development</p>	<p>Incremental Product Improvement</p>
<p>New Process Development</p>	<p>Incremental Process Improvement</p>

Note: New or incremental to the company, not the industry or world.

- Specific examples of qualifying activities include:
1. Design or development of any new software or technology products for commercial sale, lease, or license.
 2. Development of software that provides a computer service when customers are using the company's computer or software technology.
 3. Software developed as part of a hardware/software product (embedded software).
 4. Modification or improvement of an existing software or technology platform that significantly enhances performance, functionality, reliability, or quality.
 5. New architecture design.
 6. Integrating legacy applications and provisioning across virtual environments.
 7. Development of new communication and security protocols.
 8. Design of database management systems.
 9. IUS development.
 10. Developing software to improve planning capabilities as part of the supply chain process, including enhanced efficiencies and new functionality.
 11. Programming software source code.
 12. Advanced mathematical modeling.
 13. Research of specifications and requirements, domain, software elements including definition of scope and feasibility analysis for development or functional enhancements.
 14. Beta testing—logic, data integrity, performance, regression, integration, or compatibility testing.
 15. Optimization of code for product performance issues, new features, or integration with new platforms or operating systems.
 16. Research for development of applications for technology patents.
 17. Design of database backend.
 18. Developing financial analytics engines to improve forecast quality and coverage.
 19. Software development to improve system reliability and uptime and computer resource efficiency.
 20. Optimizing data access patterns.
 21. System architecture research to improve scalability, functionality, or improved performance.
 22. Software design to work with different databases.
 23. Rapid prototyping.
 24. Development related to performance issues such as systems running too slowly or bottlenecking.
- Examples of activities that will not qualify for purposes of the R&D credit include:¹⁰
1. Routine testing or inspection activities for quality control.
 2. Development related purely to aesthetic properties of a software package.
 3. Routine bug fixes.
 4. Market research for advertising or promotions.
 5. Routine data collections.

¹⁰ Section 41(d)(4).

EXHIBIT 2

Alternative simplified credit (ASC)

$$\text{ASC} = (\text{current year QRE} - (\text{average of previous 3 Years QRE} \times 50\%)) \times 14\%$$

EXHIBIT 3

Regular (traditional) credit method

$$\text{regular} = 20\% \text{ of the smaller of } ((\text{current QRE} - \text{base period amount}) \text{ or } (50\% \text{ of current QRE})) \\ + 20\% (\text{current payments to universities} - \text{base period amount})$$

EXHIBIT 4

Base period amount

base period amount = fixed base percentage \times average of the prior four years gross receipts

EXHIBIT 5

Reduced ASC credit

If the special election is made under Section 280C(c)(3), the allowable credit is determined as follows:

$$\text{ASC} = (\text{current year QRE} - (\text{average of previous 3 years QRE} \times 50\%)) \times 9.1\%$$

EXHIBIT 6

Reduced regular (traditional) credit method

$$\text{Regular} = 13\% \text{ of the smaller of } ((\text{current QRE} - \text{base period amount}) \text{ or } (50\% \text{ of current QRE})) \\ + 13\% (\text{current payments to universities} - \text{base period amount})$$

6. Research conducted outside of the U.S., Puerto Rico, or any possession of the U.S.
7. Research that is funded by a third party other than the taxpayer.
8. Any other activities that do not meet all of the four tests previously outlined.

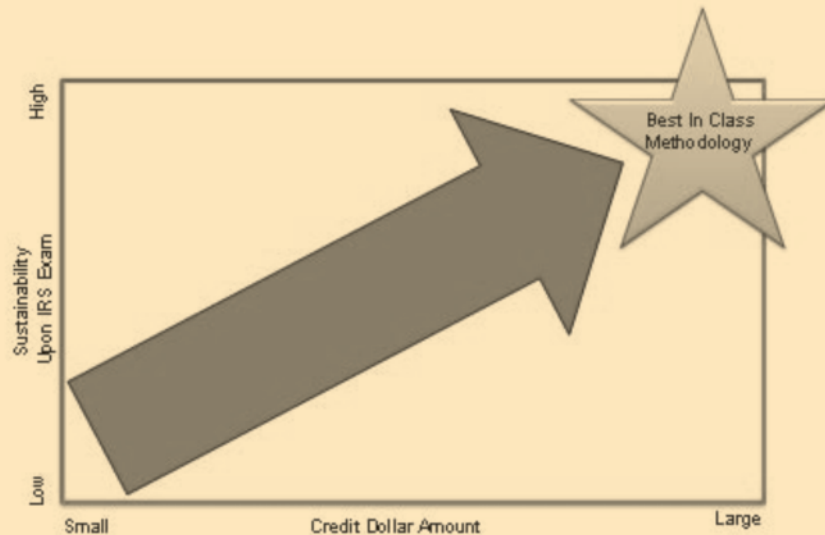
Case studies

The following are three case studies that further illustrate the types of projects and activities that will potentially qualify for the R&D credit. The eligibility of specific activities and expenditures will depend on a closer examination of the facts and circumstances in relation to applicable guidance.

Case study one—new product development. A firm launched a software project to line up bonds and repos along with associated cash funding FX trades to reflect a proper presentation of risk.

Prior to automation, this process was handled manually. Because this data was not present in the system at the right time and in a concise way, the firm's real-time position in this area was not presentable in real-time to the front office, and thus, decision making and effective risk management were hampered. Technical uncertainties that were encountered included whether the firm had the ability to automate the process to provide a real-time view of risk. Also, the firm was unable to maintain the system with the infrastructure reconciled and effectively relate records to quickly troubleshoot problems in the event of a break. The internally developed design was simulated through manual entry of the expected results, testing, and iterative trial and error. Substantially all of the activities involved in this project were technological in nature and relied on the principles of computer science. After extensive analysis of the expenditures and activities involved in this

EXHIBIT 7
Optimizing the R&D credit



project, the development was determined to qualify for purposes of the R&D credit.

Case study two—new product development.

A firm launched a software project to develop a new ad hoc reporting solution. Prior to this project, data and analysis components were contained in a web of files that were difficult to manage and maintain. The development team sought to streamline and improve on the previous system design. Within the new application, the data and analysis components are separated, with data stored in a structured manner that the analysis component can pull from automatically. The most challenging part of the development process was researching the existing web of files and formulas to come up with the general optimized theory that could be coded by the developers. The development process went through multiple iterations until the solution provided accurate results in all instances. Substantially all of the activities involved in this project were technological in nature and relied on principles of computer science. After extensive analysis of the expenditures and activities involved in this project, the development was determined to qualify for R&D credit purposes.

Case study three—new product development.

A firm launched a project to increase the performance and scale of a trading application. The project's goal was to support greater volumes of

trades at faster speeds than previously possible. In addition, the developers sought to increase the application's functionality by adding new asset classes. At the beginning of the project, the team was uncertain of the methodology to make these improvements possible. The development team was able to increase volume and processing speeds through design and implementation of a new tiered processing architecture. In addition, the developers adapted open source technologies to further scale the application. Substantially all of the activities involved in this project were technological in nature and relied on computer science principles. After extensive analysis of the expenditures and activities involved in this project, the development was determined to qualify for purposes of the R&D credit.

Calculating the R&D tax credit

There are two standard methods of calculating the Section 41 R&D credit. The credit is reported on Form 6765, Credit for Increasing Research Activities, and is included with the tax return. The methods for calculating the credit are the traditional "regular credit" method and the ASC method.¹¹ Under the traditional method, the credit is 20% of the current-year QREs in excess of a base amount. One of the factors used in the calculation of the base amount is historical QREs. Using the traditional method, some taxpayers are required to determine their QREs for years as far back as 1984.¹²

¹¹ Section 41(c)(5).

¹² Section 41(c)(3).

¹³ Note 9, *supra*.

The ASC credit is 14% of the current-year QREs in excess of 50% of the average QREs for the three tax years preceding the tax year for which the credit is being determined. Firms that have not claimed the R&D credit in the past or that may have difficulty determining their historical QREs may find the ASC to be more beneficial.

Conclusion

The R&D credit is an important competitive factor for businesses within financial services as it can lower the effective tax rate and refuel R&D efforts through increased cash flow. Federal tax credits provide permanent benefits to reduce the cost of research and development. While claiming the credit requires time, resources, and expertise, it can provide significant monetary and operational benefits to businesses. Even firms currently operating at a loss may benefit because federal R&D credits generated but not used can be carried back one year and forward up to 20 years, creating an opportunity when the firm becomes profitable. Also, if a firm is acquired, the credits may be considered a valuable future asset in negotiating a selling price for the business. When credits are claimed correctly, firms can reap benefits such as increased cash flow, optimization of engineering invest-

ments, and a dollar-for-dollar reduction in tax liability.

The R&D credit continues to be underused by qualified firms and their business management teams, particularly within the financial services industry. Reasons include a misunderstanding of qualification and documentation requirements for federal and state credits, fear of triggering an IRS audit in the current or prior year tax returns, and the perception of the credits as being limited in scope or fleeting in nature due to their persistent short renewal periods. Detailed time and project tracking help facilitate nexus considerations. Documentation is usually abundant as projects are closely tracked and monitored from start to finish. Records are generally kept contemporaneously. Planning ahead by creating an infrastructure that identifies QRAs and collects contemporaneous documentation is essential to reducing future tax liabilities and building a business's R&D credit on a more solid foundation. These are key ingredients for a successful R&D tax credit claim. After all, the final value of an R&D credit rests with its sustainability on IRS examination. (See Exhibit 7).¹⁹ It is worthwhile for firms in the financial services industry to closely examine their internal processes and think about whether they might benefit from this tax credit. ■