



ROUNDTABLE RECAP

EXECUTIVE SUMMARY	Date: Thursday, September 6 th , 2018 Time: 3:00-4:00pm EST
COMPANIES REPRESENTED:	Blackbaud, <u>Commscope</u> , Old Dominion Freight Line, Paccar, Oracle, Calsonic <u>Kansei</u> NA, K2M, UFPI, ULA, Lockheed Martin, Bayer, Health Equity, Caterpillar, AT&T, Wells Fargo, Ivins Philips Barker, Northrop Grumman, NCR, Duke Energy, Stanley Black and Decker, Victaulic
SPEAKERS:	<ul style="list-style-type: none">• Jason Massie & Peter Green MASSIE R&D Tax Credits, Alpharetta, GA• Jeff Moeller Ivins, Phillips & Barker, Washington, D.C.• Michael <u>Schlipp</u> Northrop Grumman, Falls Church, VA



TODAY'S AGENDA

1. INTRODUCTIONS AND ANNOUNCEMENTS

Peter Green and Jason Massie
MASSIE R&D Tax Credits, Alpharetta, GA

2. WASHINGTON UPDATE

Jeff Moeller
Ivins, Phillips & Barker Chartered

3. MEMBER SPOTLIGHT

Michael Schlipp
Northrop Grumman

4. AVOIDING CONTROVERSY PITFALLS

Jason Massie
MASSIE R&D Tax Credits, Alpharetta, GA

5. WRAP UP

Peter Green and Jason Massie
MASSIE R&D Tax Credits, Alpharetta, GA

US RESEARCH CREDIT PILOT MODELS



Jeffrey E. Moeller
Ivins, Phillips and Barker

Jeffrey E. Moeller is a partner of Ivins, Phillips & Barker in Washington, DC (www.ipbtax.com), one of the few law firms in the country specializing exclusively in the practice of federal tax law. Jeff has extensive experience handling planning, audit, and controversy matters involving the research tax credit and has conducted frequent seminars in this area. Jeff's experience with the credit goes all the way back to the influential brief he authored for the Aerospace Industries Association of America, as Amicus Curiae in the seminal 1996 case, *Fairchild Industries v. US*. Currently, Jeff is lead counsel for the taxpayer in *Bayer Corp. v. United States*, the largest research tax credit ever docketed.

Jeff also specializes in corporate tax planning and transactional matters and has structured and negotiated mergers, acquisitions, joint ventures, and other transactions valued in excess of one-hundred billion dollars. He specializes particularly in collaboration agreements, joint ventures and other domestic and cross-boarder arrangements involving research activities. Jeff received his law degree from the Georgetown University Law Center.

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Pilot Models

- July 2014 amendments to section 174 regulations
 - Experimental *but fully functional* prototypes are “pilot models.”
 - The ultimate sale or use of prototype does not disqualify R&E costs
 - Example 5 indicates multiple models may qualify
 - Processes may also be pilot models—tension with *Union Carbide*
 - Introduces shrink-back rule when uncertainty exists only as to a component.
 - Remaining uncertainties:
 - When is uncertainty resolved in a fluid development process?
 - What is the “pilot model” when a new component is integrated into a larger product?
 - Is the shrink-back rule a sword for the IRS or a shield for taxpayers?

Pilot Models—Example 8

- The above uncertainties come to a head in Example 8 of the Regulations (§1.174-2(a)(11)):

“Development of new component; pilot model. Y is a manufacturer of aircraft engines. Y is researching and developing a new type of compressor blade, a component of an aircraft engine, to improve the performance of an existing aircraft engine design that Y already manufactures and sells. **To test the appropriate design of the new compressor blade** and evaluate the impact of fatigue on the compressor blade design, Y produces and installs the compressor blade on an aircraft engine held by Y in its inventory. The costs of producing and installing the compressor blade component that Y incurred represent research and development costs in the experimental or laboratory sense. Because Y produced the compressor blade component to resolve uncertainty regarding the appropriate design of the component, the component is a pilot model under paragraph (a)(4) of this section. Therefore, the costs that Y incurred to produce and install the component qualify as research or experimental expenditures under section 174. See paragraph (a)(5) of this section (regarding the application of section 174 to components of a product). However, section 174 does not apply to Y's costs of producing the aircraft engine on which the component was installed. See paragraph (a)(2) of this section (relating to production costs).”

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Pilot Models

- Integration Uncertainty
 - A “pilot model” is:
 - “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”
 - “Product,” however, is:
 - “any pilot model, process, formula, invention, **technique**, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license”
 - When there is uncertainty about the *integration* of components (*e.g.*, one experimental component and one component out of inventory) the “product” is the “technique,” not the experimental component
 - The shrinkback rule does not apply to limit pilot model status to the experimental component, since the pilot model is not a model of the component but of the technique being tested
 - Is Example 8 misleading? Wrong?
 - What about two out-of-inventory components never put together before?



MEMBER SPOTLIGHT

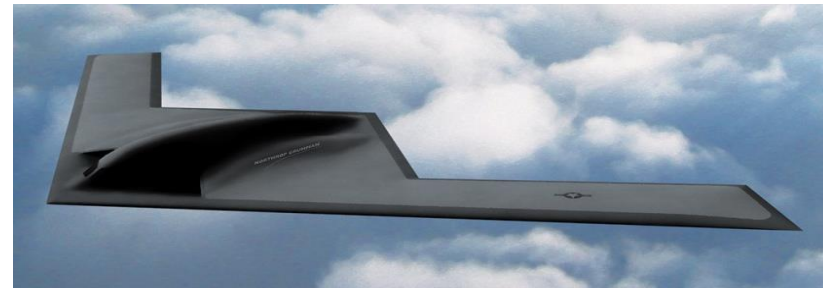
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Email: michael.schlipp@ngc.com
Northrop Grumman, Falls Church, VA



THE VALUE OF PERFORMANCE.
NORTHROP GRUMMAN

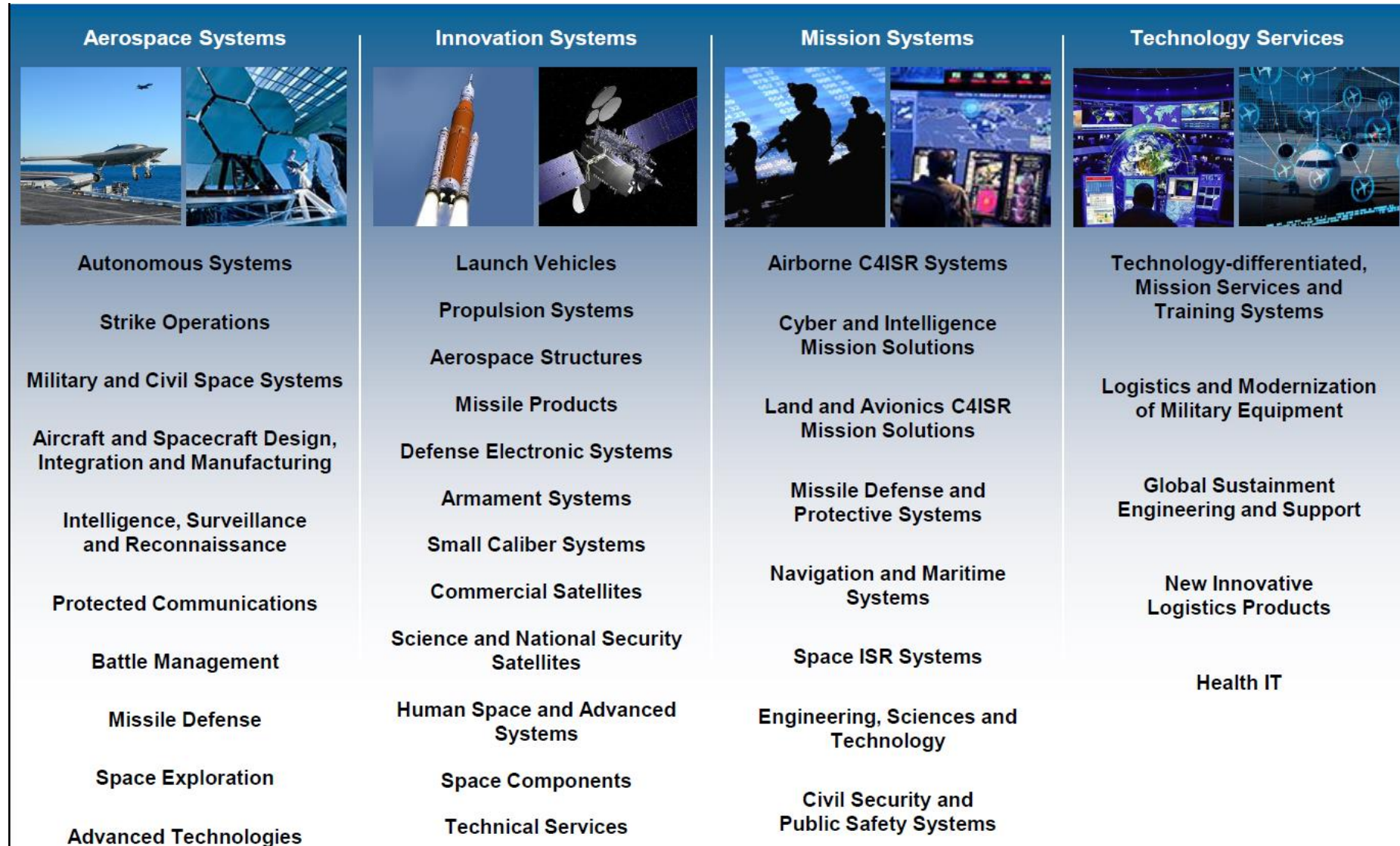
Northrop Grumman Today

- Leading global security company
- \$25.8 billion sales in 2017
 - 87% U.S. / 13% International
- \$52.2 billion total backlog
 - (as of June 30, 2018)
- Acquired Orbital ATK on 06/05/2018
 - \$4.5 billion revenue in 2016
- Leading capabilities in:
 - Autonomous Systems
 - Cyber
 - C4ISR
 - Space
 - Strike
 - Logistics and Modernization



Focus on Performance

Four Operating Sectors at a Glance



NATO AGS – Air Vehicle





AVOIDING 7 CONTROVERSY PITFALLS

Presenter: Jason Massie
Massie R&D Tax Credits, Alpharetta, GA



1. CHOICE OF REPRESENTATION
2. BIAS AGAINST PROJECT NARRATIVES
3. MISSING CONTEMPORANEOUS DOCUMENTATION
4. BROADLY DEFINING PROJECT "FAMILIES"
5. LACK OF SUPPORT FOR GOLD LEVEL EMPLOYEES
6. FAILURE TO TRAIN AND PREPARE SMES
7. SUPPORT FOR CREDIT NOT LOGICALLY ORGANIZED

CHOICE OF REPRESENTATION

SCENARIO: Research credit under exam. Do you defend study yourself, hire outside counsel, or use provider?

CHOICE OF REPRESENTATION

ISSUE:

1. You feel handcuffed to use provider given they know facts, or have data/documentation to defend.
2. You aren't really sure you know how to respond to IDRs given lack of involvement in study.
3. Don't want to change horses in midstream and fear outside counsel would be expensive.

RECOMMENDATION: Get comfortable with your claim, facts and documentation, during the study. Before exam starts consider all your representation options. Make sure your provider issues you report timely.

Trend is for IRS to fully develop facts in exam. SME witness interviews are on-going. NOPAs follow with redacted SME sound bites that are damaging. Outside counsel best suited to handle witness interviews.

If you are in midstream, don't wade too deep where you can't get out. An independent set of eyes will add new level of objectivity to your claim. Example, Reverse Audit, interviewed Gold Level SMEs due to high QRE %. Developed strategy, mitigated risks.

BIAS AGAINST NARRATIVES

SCENARIO: Providers authoring narratives/write-ups using standard phrases that seem overworked.

As a result of the uncertainties faced at the outset of each project, [REDACTED] undertook a process of experimentation to meet specific project requirements. During the design and development process, the Company encountered numerous technical challenges related to the design of new and improved [REDACTED]. In order to overcome the aforementioned uncertainties, [REDACTED] implemented a systematic process of evaluating alternative process and design solutions.

TECHNICAL UNCERTAINTY (List and describe the areas of technical uncertainty encountered during the course of the project.)

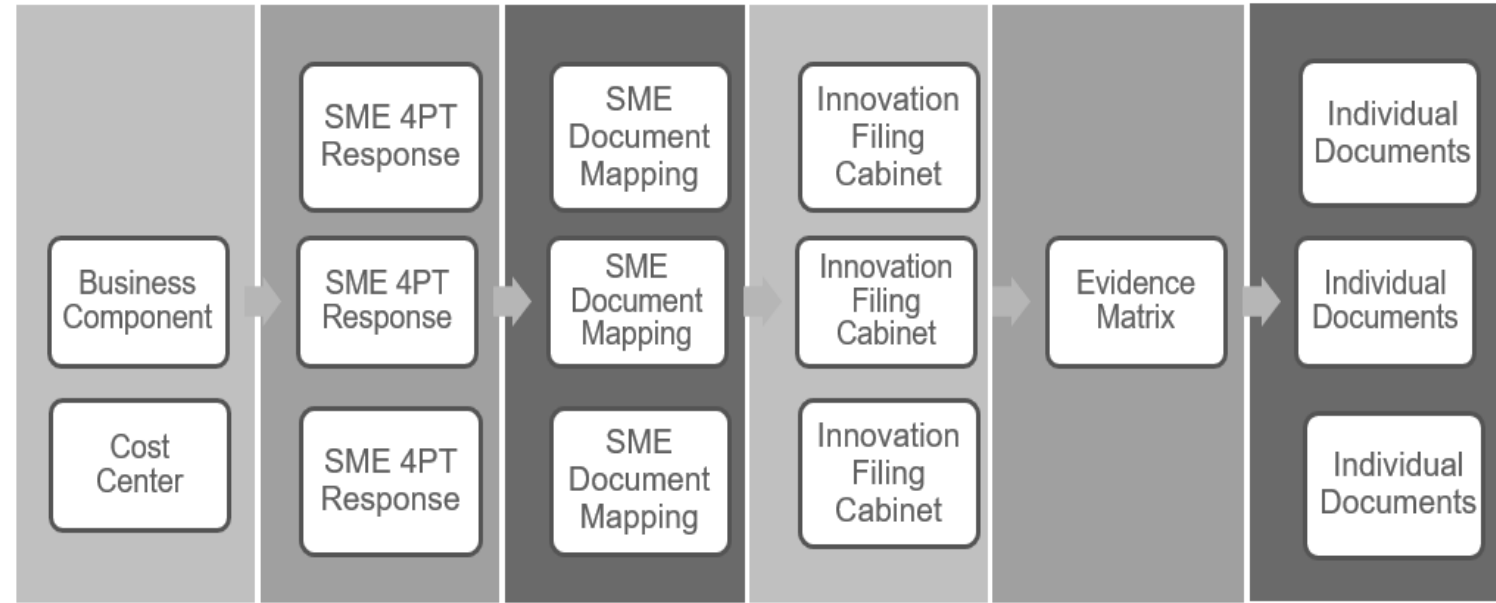
[REDACTED] was uncertain to the capability, design and methodology throughout the research and development process. Therefore, its research and development activities related to the development of the [REDACTED] satisfied the “uncertainty” requirement set out in Section 41 of the Internal Revenue Code.

BIAS AGAINST NARRATIVES

ISSUE:

1. IRS skeptical when these seem too “canned” or “pre-packaged.”
2. Lack of details sends message that facts are not available or adverse.

RECOMMENDATION: Consider whether better SME contemporaneous material exists to support projects or could be improved in the future with some added information. Engage SMEs to provide narratives themselves.



MISSING CONTEMPORANEOUS DOCUMENTATION

SCENARIO: SMEs failed to keep documents to support innovative activities, or provider work product has computations, and project narratives, but no SME contemporaneous documentation.

MISSING CONTEMPORANEOUS DOCUMENTATION

ISSUE:

1. Material QREs from projects with no documentation are at risk.
2. A work product without documentation puts your claim in jeopardy if SMEs leave company before documentation is gathered.
3. Memories fade over time and documentation may disappear.
4. Standard document destruction policy might cause evidence to get destroyed.

RECOMMENDATION: Make sure SMEs understand to keep documentation until tax year is closed. Consider more “real-time” documentation gathering. Educate SMEs on what is needed to support the credit and see if existing artifacts can be improved. Consider transcribing meetings with SMEs as some layer of support to extent none really does exist to support material QREs.

BROADLY DEFINING PROJECT “FAMILIES”

SCENARIO: Many projects are being grouped together to make 4PT easier to document.

Business Component Number	Business Component	Q/NQ
1	New Product Development	Q

This business component objective is to develop and launch new or improved products, product families or line extensions using a suitable and robust process. In addition, this grouping also focuses on activities that include a number of projects aimed at making improvements to quality and functionality to the various product lines. This development process includes the creation of products with new or unique characteristics that offer additional benefits to the customers. Development can also involve the modification of an existing product to satisfy the newly defined customer requirements or other identified technical deficiency in its performance. The deficiencies can be related to the function or performance of the product or an issue with the manufacturability of the product.

BROADLY DEFINING PROJECT “FAMILIES”

ISSUE:

1. Sub-projects really stand-alone business components.
2. IRS digging deeper into families and wanting to see 4PT and documentation for sub-projects.
3. Mad scramble for new information under pressure of IDR response time.

RECOMMENDATION: OK to group projects logically, but make sure you gather information at sub-project level just in case. Better to ask for sub detail now than later.

LACK OF SUPPORT FOR GOLD LEVEL EMPLOYEES

SCENARIO: Many examiners challenging wage QREs based on job titles. Also see situations where executives not tracking time to projects.

LACK OF SUPPORT FOR GOLD LEVEL EMPLOYEES

ISSUE:

- 1. Taxpayer not prepared to support manager and above wage QREs either through oral testimony or time tracking.
- 2. IRS getting quick and easy hits based on sorts or filters.
- 3. Taxpayers wanting to fight back are scrambling after IDRs to gather appropriate information.

RECOMMENDATION: Consider developing “Gold Level” time questionnaires. Conduct assessment of sampling of Gold Level employees to learn more about what they do. Design questionnaire to contain certain Q and NQ categories of time. Roll out questionnaires with instructions to employees. Tuck those away in file to support %. Consider pulling job profiles, org charts, and transcribing conversations with leadership as to how and when they interact with R&D teams/supporters and supervisors.

Research Credit:	Executive Questionnaire f	
Tax Year:		
Executive Surveyed:		
Job Title:	SVP, C	
GOAL: To understand activities of higher-level management		
What percentage of time during the last fiscal year did you spend on the following:		
Product Innovation (Big picture R&D, with more focus on R)		
Determining what customers want/need		
Transforming ideas into action		
Setting product visions/forward thinking planning		
Overseeing execution team leadership		
Technical Team Oversight (more into the weeds of D)		
Forming and managing execution team		
Participating/leading product development meetings		
Developing plans and process for product development		
Experimenting with product until completion		
Marketing and Sales		
Understanding and developing business channels		
Branding oversight		
Approving of marketing strategy/collateral		
Executive Leadership		
Establishing long-term strategy		
Evaluating talent		
Securing financial resources		
Identifying company culture and values		
Reviewing company progress and financials		
Addressing legal and human capital issues		
Other		

FAILURE TO TRAIN AND PREPARE SMES

SCENARIO: Lack of assistance from SMEs either during study or controversy phase.

FAILURE TO TRAIN AND PREPARE SMES

ISSUE:

1. SME “User Experience” from prior years wasn’t good, disruptive, tax not leveraging “our process.”
2. Nobody asked SMEs for feedback on how to make process better.
3. SMEs weren’t engaged before or during study, so they didn’t fully understand what project was about.
4. SMEs very hesitant to assist for fear of having to testify later. Yet SME witness interviews are real and even then SMEs not properly prepared.

RECOMMENDATION: Need *Architecture Phase* to focus on SME participation, and explain all phases of project including controversy. Make permanent improvements in SME documentation process to create contemporaneous documentation. Gather as much evidence as possible to support SMEs during the study to make controversy easier on them. Engage them in *Kick-Off* sessions (lunch and learn) at beginning. Provide training on credit and what qualifies. Improve study tools with their input.

SUPPORT FOR CREDIT NOT LOGICALLY ORGANIZED

SCENARIO: You've got great workpapers, but documentation is not consistent for all material projects or organized ("throw on wall and hope something sticks" approach).

SUPPORT FOR CREDIT NOT LOGICALLY ORGANIZED

ISSUE:

1. Blew opportunity to make a great first impression.
2. Documentation not organized properly is useless as IRS not likely to organize it for you.

RECOMMENDATION: Start with broad overview about the company's credit. Make sure computations neat and orderly. Discuss areas of research, where the R&D takes place, and by which departments. Start to drill down into areas of R&D focus, what the R&D process is at your company, SMEs, and artifacts that exist. Be clear, but not overly complex or technical. Support business component R&D with representative sample of documents that are available. Don't advocate too much on your behalf, but present facts. Try not to be argumentative in your project write-ups/narratives or use self-serving language (save that for Appeals Protest).



Next ROUNDTABLE:
Wednesday, December 12th @ 3PM EST

**THANK
YOU**