

Research & Development

R&D Tax Credit Case Study: Software Development Contractor

Company Overview:

SoftwareX is a software development firm located in Northern Virginia. The Company's primary source of revenue is from software development that it performs under contract for various clients. The Company's client base consists of a mix of private sector corporations and government entities. To complete this work, SoftwareX employs a team of full-stack developers. Its also utilizes contracted software engineers throughout the U.S. and in Costa Rica as part of its projects. In 2016, the Company began allocating resources towards projects aimed at producing new software products that it intended to sell, lease, or license to entities in the private and public sectors. To complete all software development initiatives, SoftwareX utilized the Agile development methodology.

R&D Credit Analysis:

Alternate Tax Solutions (ATS) was contracted to review all software development activities from 2016-2019 to determine if there were any expenses that could be allocated towards the R&D Credit under Section 41 of the Internal Revenue Code. A review of all contracts, internal software development projects, and software development activities was conducted. Section 41, as well as the *IRS Audit Techniques Guide* and various Tax Court rulings, were used to identify qualified versus non-qualified research.

Qualified Research Findings:

Contracted Development (Private Sector): All of the contracted development SoftwareX performed for clients required a process of experimentation to be used to overcome technical uncertainties. However, this work failed the *business component test* of Section 41 since a majority of the contracts stated that SoftwareX would be paid for the number of hours worked. Additionally, the client retained all rights to intellectual property produced as part of the software process. Therefore, this work was considered “funded” research and was excluded from any R&D Credit calculation.

Contracted Research (Public Sector): During the covered period, SoftwareX was awarded one contract to develop a new processing algorithm to be delivered through software for an agency in the defense sector. This work was found to constitute qualified research since: 1) the contract had a fixed-price structure and required the Company’s solution to be tested at certain milestones and 2) the contract contained an FAR clause that allowed SoftwareX to exploit the results from all development on future projects and products.

Internal Product Development (IR&D): Each year, the Company dedicated various resources towards the creation of various software solutions that it intended to sell, license, or hold as internal intellectual property. The majority of these resources surrounded attempts to create a new resource management platform. All of this work was purely exploratory and experimental in nature and the Company utilized its Agile framework to develop and test the code and architecture.

Qualified Research Activities (QRAs):

It was found that the work the Company performed on its public sector software development contract and IR&D projects passed the four-part test established in Section 41 of the IRC. Qualified research activities undertaken as part of these efforts included:

- Product ideation and white-boarding meetings
- Establishing feature functional requirements through user stories
- Development of architecture governing new software features at the database, business logic, and UI layers of software
- Analysis of alternative tools and libraries needed to meet functional requirements
- Proof-of-concept tests on alternatives
- Developing conditional algorithms to perform proprietary functions through software.
- Sprint cycle planning and resource allocation
- Writing and testing code for back-end and front-end applications
- QA engineering
- Writing test scripts
- Development of cloud-based architecture for AWS deployment
- Prototyping AWS vs. Azure cloud options
- DevOps engineering
- Staging software for pre-production testing
- Iteration on code and architecture to eliminate deficiencies

Developing new architecture and proprietary algorithms allowed SoftwareX to show that it was engaged in research that the *IRS Audit Technique Guide* has stated “rarely fails to constitute a process of experimentation.” This relied on principles of computer science to eliminate uncertainties the Company faced when attempting to produce a successful end state. Therefore, the QRAs connected to the government research contract and IR&D projects were found to pass the *four-part* test of the IRC.

Qualified Research Expenses:

To calculate the R&D Credit, ATS was able to isolate hours spent in the process of experimentation on all qualified projects. The hours of software developers, development managers, and support personnel performing user testing were identified. These hours were divided against the total hours worked to determine the QRE percentage. This percentage was multiplied against the W-2 of each employee. The same process was performed for all U.S. contractors involved in QRA.

R&D Credit Results:

ATS was able to utilize the revenues and expenses in the years prior to 2016 to calculate the R&D Credit using the regular method for start-up companies, as well as the alternative simplified credit method. Since the Company had never claimed the Credit under the regular method on any amended returns, it would be able to use whichever calculation produced the highest results.

Year Year	2016	2017	2018	2019
Total QREs	\$ 642,111	\$ 858,637	\$ 972,225	\$ 486,604
Total Tax Credit	\$ 64,211	\$ 85,837	\$ 97,222	\$ 36,495
Net Tax Benefit	\$ 41,737	\$ 55,794	\$ 76,805	\$ 28,831

Total Tax Benefit: \$203,167

Total Return on Engagement: 13:1

Conclusion

In 2019, SoftwareX spun off the development operations for its proprietary resource management platform into a separate company. ATS was contracted to perform R&D Credit analysis services for that entity as well. Through an in-depth analysis of all operations at the Company by R&D Credit subject-matter experts, SoftwareX was able to maximize its R&D Credit while ensuring that it avoided claiming any expenses that would be disallowed under review by the IRS. ATS also worked with SoftwareX and its new sister entity to establish the systems needed to claim and sustain R&D Credits each year going forward.



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