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SETTLEMENT GUIDELINES

WAGES OF TECHNICAL WRITERS AND THE RESEARCH CREDIT

STATEMENT OF ISSUE

Whether wages paid to technical writers, editors, illustrators, and others for services in the preparation of user manuals (hereinafter referred to as "writers") constitute a "qualified research expense" for purposes of computing the research credit under section 41.

EXAMINATION DIVISION'S POSITION

Wages paid to writers for services in the preparation of user manuals do not constitute a "qualified research expense" for purposes of computing the research credit under section 41.

DISCUSSION

Taxpayers in the data processing industry employ writers to prepare and update documents that are used by the sales division to explain to its customers and other interested parties how to operate the equipment and software they sell or lease. The ultimate goal of this documentation is to produce a user manual to be associated with the product to instruct the customer or other interested parties in the operation of the product.

The taxpayers contend that even though the ultimate goal of the writers is to produce user manuals, many of their duties, which may go beyond the duties defined in their job descriptions, involve participation in qualified research.

The Economic Recovery Tax Act of 1981 provided a tax credit that is based on a

taxpayer's increased spending for "qualified research." The credit first appeared in section 44F. The Deficit Reduction Act of 1984 redesignated section 44F as section 30. The Tax Reform Act of 1986 amended the research credit provisions and redesignated section 30 as section 41.

For taxable years beginning before January 1, 1986, the term "qualified research" generally has the same meaning as the term "research or experimental" has under section 174. See section 44F(d) or section 30(d). Treas. Reg. § 1.174-2 defines "research and experimental expenditures" as

expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned.

See also Mayrath v. Commissioner, 41 T.C. 582 (1964); Reiner v. Commissioner, T.C. Memo 1965-197; Kollsman Instrument Corp. v. Commissioner, T.C. Memo 1986-66; and Agro Science Co. v. Commissioner, T.C. Memo 1989-687, aff'd, 927 F.2d 213 (5th Cir. 1991), cert. denied, 116 L. Ed. 2d 243.

In Mayrath, the court found that the legislative intent of section 174 was to "limit deductions to those expenditures of an investigative nature expended in developing the concept of a model or product." (This decision was affirmed (357 F.2d 209 (5th Cir. 1966)) on the basis that the taxpayer lacked the requisite profit motive.)

In Reiner, the court quoted from Mayrath, but allowed a portion of the research and development expenditures in question based on a Cohan-type estimate. See Cohan v. Commissioner, 39 F.2d 540, 544 (2d Cir. 1930).

In Kollsman Instrument Corp. and in Agro Science Co., the court found that the expenses in question did not constitute research or experimental expenditures under Treas. Reg. § 1.174-2(a) because the taxpayers were not attempting "to invent or to develop the concept or design of any product." The Agro Science Co. court noted that Code section 174 "requires some element of experimentation." (The Kollsman Instrument Corp. decision was

affirmed (870 F.2d 89 (2d Cir. 1989)) on other issues. The Agro Science Co. decision was affirmed (927 F.2d 213 (5th Cir. 1991)) on the basis that the taxpayer lacked the requisite profit motive. However, in footnote 2 of the Agro Science Co. appellate opinion the Court of Appeals cautioned the Tax Court "against employing its ill-suited forum to distinguish science from folly, except possibly in the most extreme cases.")

The Tax Reform Act of 1986 amended the definition of "qualified research" for purposes of the research credit for taxable years beginning after December 31, 1985. Generally, section 41(d) now provides that qualified research is research that

(1) the cost of which is deductible under section 174;

(2) is undertaken for the purpose of discovering information that is technological in nature, where such information is intended to be useful in the development of new or improved products or property; and

(3) consists substantially of activities involving a process of experimentation designed to improve the functional rather than the stylistic aspects of a product.

According to the Conference Committee Report on the Tax Reform Act of 1986, activities are technological in nature if they fundamentally rely "on principles of the physical or biological sciences, engineering, or computer science."

The 1986 amendment does not apply retroactively. However, the court in TSR, Inc. v. Commissioner, 96 T.C. 903 (1991), relied on the legislative history of the 1986 amendment coupled with the legislative history surrounding the original enactment of section 44F in concluding that "restricting the credit to research that is 'technological in nature' was consistent with Congress' original intent when it adopted section 44F in 1981." Notwithstanding the opinion in TSR, Inc., the Service takes the position that the more restrictive definition of "qualified research" is applicable to taxable years beginning after December 31, 1985.

Section 41(b)(1) provides that qualified research expenses include "in-house research expenses" and "contract research expenses." Generally, in-house research expenses include only wages paid or incurred to an employee for "qualified services," and amounts paid for supplies used in the conduct of qualified research. "Qualified services" include the actual conduct of qualified research and direct supervision or direct support of research activities which constitute qualified research.

Treas. Reg. § 1.41-2(c)(1) provides that "[t]he term 'engaging in qualified research' ... means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments)."

Treas. Reg. § 1.41-2(c)(2) provides that "[t]he term 'direct supervision' ... means the

immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). `Direct supervision' does not include supervision by a higher level manager to whom first-line managers report, even if that manager is a qualified research scientist."

Treas. Reg. § 1.41-2(c)(3) provides that "[t]he term `direct support' ... means services in the direct support of either -- (i) Persons engaging in actual conduct of qualified research, or (ii) Persons who are directly supervising persons engaged in the actual conduct of qualified research."

Accordingly, expenses which qualify for the research credit include not only the wages paid to employees engaged in qualified research, but also include wages paid to their first-line supervisors and to personnel who directly support either the researchers or the researchers' first-line supervisors.

Taxpayers contend that the writers perform two distinct functions, one of which involves the actual writing of the user manuals and the other of which involves participation in the research and development process. Some taxpayers also contend that in order to bring new products to market more quickly they put together teams to conduct research and development and that the writers are members of such teams.

Taxpayers contend that during the "Alpha" (initial design) phase of a new product the writers are involved directly in the research and development activities and directly support other team members engaged in research and development. The writers allegedly perform continuous trial and error testing against current design specifications during the Alpha stage. They locate flaws in the product and propose changes to the product or to the design specifications. The taxpayers contend that this Alpha stage quality review is integral to the research and development process because the product is subject to significant design changes throughout the Alpha stage.

In addition to the above, the taxpayers contend that the writers are also involved in the following research and development activities:

- (1) instructing program writers regarding the design of the user interface;
- (2) designing and writing the "Help" functions;

(3) preparing contemporaneous documentation of the engineering process during the Alpha stage; and

(4) assisting in the preparation of prototype documentation which is used for on-site testing of the product at a customer's facility ("Beta site") prior to the release of the product to manufacturing.

Thus, taxpayers assert that writers, to the extent they are involved in the research and development process, are performing "qualified services" within the meaning of section 41(b)(2)(B).

SETTLEMENT GUIDELINES

The settlement of this issue should be based on a factual determination of the duties actually performed by the writers and what portion, if any, of those duties constitute "qualified services."

This determination should be based upon the following criteria:

(1) a detailed description of the departments in which the writers worked (This description should be from a source that was in existence during the year in which the credit was claimed);

(2) organizational charts showing where the technical writers fall within the company and to whom they report;

(3) job descriptions for each position that the taxpayer contends contains an element of qualified research, direct supervision, or direct support;

(4) job announcements and vacancy announcements for the technical writers positions;

(5) the educational and technical backgrounds of the writers the taxpayer claims are involved in qualified research;

(6) affidavits from writers employed during the years at issue describing their duties and the approximate percentage of their time that was devoted to the various duties; and

(7) affidavits from the engineers who were involved in qualified research during the years at issue regarding the participation of the writers in the research and why the writers' involvement was necessary.

Particular attention should be paid to the following areas.

1. Do the activities of the writers constitute qualified research?

This is, of course, a factual question. However, especially with respect to such duties as writing the "Help" functions of software programs, consideration should be given to the

question of whether these duties constitute activities that are "experimental in the laboratory sense" and "technological in nature" (especially for years beginning after December 31, 1985). It would appear that the writing of the "Help" function involves no more than the writing of an on-screen version of the user manual and, therefore, does not constitute an activity that is "experimental in the laboratory sense" and "technological in nature."

Also, consideration should be given to the question of whether customer site "Beta" testing constitutes qualified research. It should not be assumed that Beta testing constitutes qualified research. The determination of whether wages of writers involved in Beta testing qualify for the credit should be made on the basis of the actual duties performed rather than relying on the "Beta testing" designation.

2. If the taxpayer claims the writers "support" qualified research, is the support "direct"?

Treas. Reg. § 1.42-2(c)(3) is cited, in part, above. The regulation goes on to cite examples of direct support:

the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research.

The regulation goes on to provide that direct support does not include:

general administrative services, or other services only indirectly of benefit to research activities. For example, services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research.

Accordingly, the nature of the writers' activities must be examined to ascertain whether

the activities are administrative in nature or directly support the qualified research.

3. Do the educational and technical backgrounds of the writers qualify them to perform the duties as claimed by the taxpayer?

The fact that the writers do not have engineering degrees should not be considered as a controlling factor, especially when the taxpayer is claiming the wages paid to the writers as "direct support." However, if the taxpayer is claiming that the writers were actually engaged in research of a technological nature, the fact that one or more of the writers are, for example, English majors, should be considered in weighing the taxpayer's credibility.

4. If the taxpayer claims that the wages paid to the writers' managers qualify for the credit, are all of the managers in question "first-line" managers?

Treas. Reg. § 1.41(c)(2), cited above, deals with "direct supervision" and specifically excludes "supervision by a high level manager to whom first-line managers report." Also, Treas. Reg. § 1.41(c)(3) provides that "[d]irect support does not include supervision. Supervisory services constitute 'qualified services' only to the extent provided in paragraph (c)(2) of this section."

Accordingly, the wages paid to supervisors beyond first-level supervisors do not qualify for the credit as either "direct supervision" or as "direct support." (This is not intended to automatically preclude all wages paid to higher level managers from qualifying for the credit. If, for example, one of the duties of a higher level manager is the direct supervision of personnel involved in the conduct of actual research, the higher level manager would be considered to be a first-line manager with respect to such duties.)

5. Who writes the user manuals?

Treas. Reg. § 1.41-2(d)(1) provides that "[i]f an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense." The regulation states that the allocation should be based on time spent on qualified services unless the taxpayer can demonstrate a more appropriate allocation method.

Treas. Reg. § 1.41-2(d)(2) provides that if at least 80% of the wages paid to an employee are for qualified services then all of the wages paid to that employee may be considered as a qualified research expense. Obviously, it is in the interests of the taxpayers to argue for a high allocation to qualified services. Any allocation of 80% or greater would result in 100% of the employees wages qualifying for the credit under this rule. If a taxpayer claims a high allocation of writers' time to qualified services, the allocation should be closely examined. While writers may be engaged in rendering some form of qualified services, the primary function of the technical writing departments is to produce user manuals. Accordingly, the duties of technical writers generally would not constitute qualified research. The burden of proof is on the taxpayer to show that the technical writers perform duties beyond the writing of the user manuals and that these duties constitute qualified services.