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## **R&D TAX CREDITS: SOMETIMES OVERLOOKED, BUT QUITE VALUABLE TO OIL AND GAS COMPANIES**

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Research and development (R&D) spending generates considerable economic activity among all businesses, including oil and gas companies. Oftentimes companies in the oil and gas and oil services industries conduct significant amounts of R&D without taking advantage of the benefits of the R&D tax credit.

The R&D tax credit was originally enacted as part of the Economic Recovery Tax Act of 1981, has expired five times, and been extended 14 times. The R&D credit was most recently extended to be available to taxpayers for the 2012 and 2013 calendar years as part of the American Taxpayer Relief Act of 2012. The R&D tax credit enjoys considerable political support among both parties, making it likely that it will be continually extended.

A look at global and U.S. levels of R&D activity in general helps provide perspective regarding the potential value of the R&D credit. Battelle Memorial Institute, a global research and development organization, and *R&D Magazine* published the *2013 Global R&D Funding Forecast* in December 2012. The forecast projected worldwide R&D spending for 2013 at more than \$1.4 trillion, representing 1.8 percent of global gross domestic product (GDP). R&D spending in the United States was projected to be \$507 billion, or 2.7 percent of U.S. GDP.

Of the projected \$507 billion of 2013 U.S. R&D spending, more than \$280 billion is projected to be performed by private industry. A significant portion of this \$280 billion spending will qualify for the federal R&D tax credit.

### **R&D Spending within the Energy Industry**

During 2012, there was \$17.9 billion of global R&D spending within the energy sector, with over \$6.6 billion of that R&D being performed by U.S. industry. Based on historical trends, it is estimated that approximately 20% of the projected \$6.6 billion in U.S. based energy sector R&D will be performed by small to mid-sized privately owned businesses. Based on

these assumptions, it is feasible that there could be as much as \$1.3 billion in R&D expenditures incurred during 2013 by privately owned businesses, many of whom are not currently claiming the R&D credit. Numerous oil and gas industry activities may qualify as R&D activity, and companies in the energy sector should evaluate their operations to identify R&D activities whose costs may qualify for the R&D credit.

Improved analytics and software may enable an oil and gas company to more accurately interpret reservoir studies for exploration and production purposes. New hardware may be developed for wells and drilling platforms, thereby making those processes more efficient. In addition, refinements may be made to pipelines and other midstream infrastructure, while new processes may also be devised for downstream functions.

While such activities may qualify for the R&D tax credit, companies need to be aware of how R&D activity is defined for U.S. tax purposes to conduct an accurate analysis of potentially qualifying activities. The primary guidance defining qualifying R&D activities is found in internal revenue code (IRC) sections 41 and 174.

#### **Defining Research and Development Activity for Tax Credit Purposes**

Treasury regulations section 1.174.2 (Regs. §1.174.2) defines qualifying research and experimental expenditures as activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. The activity must meet these two criteria:

- It must be related to the development or improvement of a “product,” inclusive of a technique, invention, formula or process; and;
- It must address uncertainty regarding the appropriate method or design for the product.

Laboratory evaluations or prototype developments likely come to mind when considering research and development tasks, and such activities certainly meet the qualifications contained in Regs §1.174.2.

A qualifying activity encompasses a multitude of other costs associated with developing or improving a product, such as: well design and recovery analysis, site engineering, production process design and development, and field trials.

Whether or not a cost qualifies as an R&D expenditure depends upon the nature of the activity, and not the nature of the product or the magnitude of the improvement. With those criteria, Regs. §1.174.2 emphasizes the importance of activities that promote incremental enhancements and improvements.

Testing performed in standard quality assurance processes does not qualify as an R&D activity, nor does research conducted after the beginning of commercial production of the business component. Reverse engineering does not qualify, nor does any research conducted outside the United States, Puerto Rico or any U.S. possessions. Research funded by grants, contracts, another person or other entity – including various governmental units – also does not meet the qualified research definition.

Activities deemed eligible by §174 qualify for immediate tax deduction may also qualify for the R&D credit under §41, if the following additional criteria are met:

- The activity must be technological in nature (i.e. based in hard sciences, such as geology or engineering).
- The activity must contain a sufficient degree of development uncertainty.
- The activity must contain the process of experimentation.
- The activity must have a permitted purpose that improves a business component.

A “business component” may be a product, process, software, technique, formula or invention.

In addition, several decades of case law have resulted in rulings that further define what expenses may be claimed for the R&D tax credit. While those cases helped establish precedents for the acceptance or rejection of various R&D tax credit claims, the sheer volume of background and historical information can appear daunting. As a result, it can keep an oil and gas company from pursuing R&D tax credits to which it may be entitled.

Being aware of the standards enables oil and gas companies to determine what specific activities may qualify for the R&D tax credit.

### **Examples of Qualifying Industry Research and Development Activities**

Within the oil and gas industry, many activities and costs that qualify for the R&D tax credit are not properly identified and utilized to claim tax credits that are statutorily available. There are R&D related tax savings opportunities to be had within every element of the exploration and production (E&P) phase.

Certain elements of geological surveys and geophysical analytic processes incorporate the elements required by §1.174-2 and §41. In addition, many of these types of activities generate costs categorized as intangible drilling costs (IDC) and should be examined for purposes of the R&D tax credit.

From “wildcat” exploration to the drilling of a well to the development of logistical infrastructure, the entire exploration and production (E&P) process is one that seeks to resolve uncertainties that are based in hard sciences. Due to the overall uncertainty, and the overriding objective of the energy sector to extract, transport, or refine more natural resources at a lower cost, the primary elements defined by sections 41 and 174 are present in many activities performed within the industry.

Modifications and incremental improvements made to wells and other field equipment may qualify as R&D activities, as would some activities associated with midstream of transportation of oil and gas. Various processes involved in downstream functions would likewise qualify as R&D expenses.

Being aware of qualifying activities enables an oil and gas company to identify what costs associated with a particular activity may be claimed for R&D tax incentive purposes.

### **Costs That Qualify for R&D Tax Credits**

Wages paid to employees for engaging in qualified research, directly supervising qualified research or supporting qualified research are included in costs eligible for the R&D credit. A company may also deduct 65 percent of contract labor costs associated with qualifying R&D activities.

The costs of tangible property consumed in the process of research and development, or used in the construction of a prototype can be qualifying expenditures for purposes of the R&D tax credit. Supply expenses, though,

cannot include land or land improvements, or property subject to depreciation. Expenses for royalties, shipping or travel cannot be included as eligible costs, either.

There are also special considerations that apply for Internal Use Software (IUS) that companies in the oil and gas industry may develop and utilize.

### **IUS Considerations**

In addition to other activities that may qualify for R&D tax credits, attention should be given to IUS, which may meet the §41(d) definition for qualified research. The following three criteria must be met:

- The software must be innovative in that it is intended to result in a reduction of cost, improvement in speed, or other improvement which is substantial and economically significant.
- The software development must involve significant economic risk in that the taxpayer commits substantial resources to the development and there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period, and;
- The software is not commercially available for use in that the software cannot be purchased, leased or licensed and used for the intended purpose without modifications that would satisfy the requirements of the immediately preceding paragraphs (.).

Oil and gas companies and the vendors serving the industry rely heavily on analytics and other software tools to mitigate inherent risks. A company may decide that developing its own software will enable it to meet internal needs more effectively than products available from software vendors.

An engineering firm, for example, may be called upon to evaluate volumes of oil or natural gas in a reserve. The firm may have developed software internally; software it feels gives it a competitive advantage over similar firms. The software enables the firm to conduct a detailed reservoir analysis in less time, thereby resulting in substantial and economically significant improvements.

Economic risk does not have to entail a potential adverse financial hardship. It can simply mean the IUS might not deliver the anticipated return on investment (ROI). Since the engineering firm invested

considerable resources in developing the software with the expectation of substantial ROI, the software development would meet the second IUS criterion.

Finally, because the firm does not market the software as a distinct product or stand-alone service to customers, it would meet the third IUS criterion.

IUS claims are subject to considerable scrutiny, scrutiny a company must be aware of when claiming a credit for such activity. Once a company has determined its software development or another activity meets the R&D qualifications, it needs to determine the value of that credit.

### **Methods for Determining the R&D Tax Credit**

When an oil or gas company determines an activity qualifies for an R&D tax credit, it must then assign a credit value to that activity. There are two methods that can be deployed for assigning that value: The Traditional Credit Method, and the Alternative Simplified Credit (ASC) Method.

The Traditional Credit Method provides a taxpayer with a credit equal to 20 percent of the excess of qualified research expenses (QRE) for the current tax year. That amount is arrived using a base amount calculation.

The base period will vary from one company to another. It is determined in part by the number of tax years the company has been existence for which it has QREs. For a company that started having QREs after 1993, the fixed-base percentage begins at 3 percent of gross receipts spent on QREs for the first five years. The fixed-base percentage may then increase during the subsequent five years. The fixed-based percentage, though, may not exceed 16 percent.

With the Traditional Credit Method, a company may also use 50 percent of current year QRE as its base amount. The company must choose the lowest base amount arrived at using those two formulas.

The Traditional Credit Method can be complicated. A company whose sales have grown at a faster rate than its QREs might also suffer in tax treatment because the base amount is determined by the ratio of QREs to gross receipts. In such cases, substantial increases in QRE would still equate to a lower ratio that could be used for calculating the value of the R&D credit. Depending upon circumstances, a company may prefer to use the ASC Method.

The ASC Method uses a base amount equal to 50 percent of the average annual qualified research expenditures claimed by a company for the three immediately preceding tax years. The excess of current year QREs over that base is then multiplied by 14 percent to determine the credit. Special rules also apply for first-time credit claims and start-ups.

In addition to utilizing those two formulas, taxpayers using the Traditional Credit Method can make an IRC §280C election. With that election, the credit amount is multiplied by .65. The §280C election must be made on an original, timely filed tax return. Credit attained through the §280C election is not added to the taxpayer's income. The §280C election is appealing to taxpayers in higher tax brackets. Also, without a §280 C election, any claimed expenditures ultimately disallowed in an IRS examination may not be deductible.

In addition to federal R&D credits, oil and gas companies should also explore applicable state R&D credits.

#### **State R&D Credits**

Tax codes in general vary immensely from one state to another. That is a crucial concern for oil and gas companies seeking to claim R&D tax credits. Upstream and midstream companies in Alaska, for example, extract and transport considerable volumes of oil. The state, however, does not offer an R&D tax credit.

Colorado, which is home to a thriving energy industry, offers a 3 percent R&D tax credit, but qualifying activities must take place within designated enterprise zones.

Louisiana offers up to a 40 percent R&D tax credit for qualifying activities taking place within the state. North Dakota bases eligibility for its R&D tax credit on §41 criteria. The percentages for the credit vary, based on the particular tax year(s) for which the credit is being claimed.

Texas originally offered an R&D tax credit, but that credit was repealed for any reports due on or after January 1, 2008. On June 14, 2013, HB 800 was signed into law, providing a sales and use tax exemption and a franchise tax credit related to qualified R&D activities taking place within Texas.

Each oil and gas company needs to determine in which states it has tax nexus, identify which of those states offer an R&D credit, and what steps must be taken to attain such credits.

After determining that activities may qualify for R&D tax credits at the federal or state levels, a company then needs to evaluate what internal steps it should take to capture those tax credits.

### **Steps for Capturing R&D Tax Benefits**

Meeting tax reporting requirements and capitalizing on potential tax benefits needs to be an ongoing process. Such an approach is needed to benefit from R&D tax credit opportunities. That approach begins with examining what projects or functions within the company have activities that may qualify for the R&D tax credit.

Where such activities may be occurring is influenced in part by the industry sector. An upstream oil and gas company needs to examine how it identifies potential reservoirs and how it extracts oil or gas, based on criteria defined by §1.174.2 and §41. Such examination needs to consider analytics and intellectual property as well as equipment and physical processes.

A pipeline company in the industry's midstream sector may have devised means to more efficiently monitor flows of oil and natural gas or overcome adverse field conditions in placing a pipeline.

Within the downstream sector, various processes for purifying or refining natural gas or oil may have been improved giving a company a substantial business benefit.

Companies that provide services to oil and gas companies can likewise evaluate internal projects and functions to determine where R&D activity may be occurring.

When R&D activities are identified, a company needs to determine how such costs are tracked. How are labor costs tracked for internal employees? What about contractor and vendor expenses? What supplies or materials are used, and how are those costs recorded?

Being aware of how such costs are identified and documented enables a company to define what it can claim for an R&D tax credit. Determining the formula to apply in determining the tax credit would take into account the taxpayer's historical QRE and gross receipts.



Individuals responsible for R&D activities should be interviewed. Those individuals can describe exactly what activities are taking place, what steps and processes are involved, and what costs are incurred. Such interviews also help those individuals gain awareness of what needs to be documented, and how R&D activities may be defined.

Conducting such internal analysis can be an expansive task. If necessary, company managers should consult with a tax advisor for assistance in both identifying and tracking R&D activity.

### **Issues to Consider for Potential Examinations**

In the event a company's tax return is examined and audited to determine whether or not its claims for R&D credits are valid, there are several factors that will be considered.

The first is the nexus between costs and activities. A company needs to demonstrate that costs factored into the R&D credit claim are indeed relevant to the R&D activity for which they are being attributed. That is why documentation for all process steps and related expenses is so crucial. The company also needs to be able to explain the calculations used to arrive at tax credit totals.

The process of experimentation, which defines R&D activity, must be documented. That documentation must demonstrate the activity meets the criteria provided in §1.174.2 and §41.

The company must also be able to identify the business component, which can be a product, process, software, technique, formula or invention held for sale in use of the taxpayer's trade or business.

Many state tax codes are based upon federal tax code, but differences arise among tax jurisdictions. Steps taken to capitalize upon federal R&D tax credit opportunities also need to acknowledge state R&D tax credit criteria.

**Long-Term Benefits Make Pursuing R&D  
Tax Credits Worthwhile**

The oil and gas industry faces considerable risks and capitalizing upon potential business opportunities requires considerable capital investment as well. Research and experimentation are necessary to mitigate risks and to make those capital investments as worthwhile as possible.

The R&D credit enables oil and gas companies to realize substantial tax benefits that may be attained from those activities. Attaining those benefits requires being aware of where such opportunities may exist, and what conditions must be met to meet requirements defined in §1.174.2 and §41.

For current and future tax years, a company must establish processes and documentation to realize those benefits and satisfy questions that may arise in a tax return examination.

Claiming R&D tax credits may require such effort, but the immediate and long-term tax savings make that effort worthwhile.