

R&D Tax Credits for Game Development Just Might Keep YOU in Play!

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Most game developers spend their time developing new and novel games, and few have teams of accountants and lawyers studying every aspect of the tax code for them. As a result, most software/game developers pay more taxes than they should.

Considering the expensive and rapidly rising costs of software development, the current video game development cycle has become increasingly difficult to sustain. Many gaming companies, feeling trapped by rising overhead, have begun outsourcing their development in order to cope. The recent economic downturn has only made things worse for companies struggling to grow or get by. With the economy struggling to recover and costs continuing to rise, it is crucial for every company to be prudent and make sure they are claiming all of the tax credits to which they are entitled. One of the largest credits available to software developers – and one that is often overlooked – is the Research and Development Tax Credit.

So, what is the R&D tax credit, and how do I know what qualifies?

The R&D credit is a reward for taxpayers that perform qualified research activities domestically. The credit is not new: it was created in the 1980s during a similar recession, with the goal of keeping high-paying technical jobs in the U.S. Throughout the last thirty years, the credit has constantly been extended and expanded. In the current market environment, the R&D tax credit acts much like a job credit, as employers can recover portions of the costs paid to employees who conduct qualified research activities. Lowering the true cost of employees can help companies fight layoffs or even put them in a position to hire more people.

To be considered “Qualified Research” for the R&D tax credit, research activities generally must satisfy four requirements or “tests.” The first test is that you have to be developing new or improved software for a qualified purpose; the second test is that the work must be based on a hard science (such as computer science, electrical engineering, or mechanical engineering); third,

some uncertainty must exist before or during development; and finally, developers must attempt to eliminate the uncertainties through a process of experimentation.

To help you relate this credit to your own development efforts, let’s look at how one of our firm’s clients passed the four-part test. The example we will use is a game developer that specializes in online, multiplayer strategy games. Like most game developers, this company employed teams of programmers and engineers to design and develop components such as a graphics engine, network infrastructure, and robust AI within the game. In addition, they employed QA specialists, a dedicated build team, and design directors who supervised the development tasks associated with each project.

New or Improved Business Components.

The regulations that define the R&D Tax Credit require that any eligible piece of software must be intended for sale, lease, or license, or it must be used to conduct the taxpayer’s trade or business. However, it is not necessary for a software company to successfully complete or release the product. (This is a great way to help recover costs for failed projects.) Qualified development activities may include the addition of new functionality within the software, but also includes the improvement of software’s functionality, performance, or reliability (the “permitted purposes”).

Our client was developing new features that it had not developed before and enhancements to its AI and network infrastructure to reduce latency during playback. While working on its core online game, the company also had begun working on its next generation graphics engine. The company abandoned the graphics engine project, but was able to recover some of its losses related to this project as R&D costs.

Hard Sciences. Recent modifications to the tax code regulations have made it much easier for software companies to satisfy this test. The current regulations require only that taxpayers rely on existing principles of a hard science in their development process in order to qualify. The prior rules required

that your work had to be expanding the field of science that you were working within (building something like the next space shuttle). Our gaming company based all of its coding and development on principles of computer science (computer science is a specific enumerated example of a “hard science”).

Be aware that it is OK to qualify portions of projects (it isn’t an all or nothing approach). If you have projects that have qualified portions and parts that may not qualify, such as the time spent on aesthetic work (e.g. artwork for icons, characters or scenery), your R&D tax credit advisor can work with you to identify the qualified portions and accurately claim the credit.

Uncertainty. Meeting this requirement requires uncertainty of only one of the following three types:

1. Uncertainty as to capability, or whether it is possible to develop the new or improved software component according to its design requirements.
2. Uncertainty of methodology, or how to develop the software most effectively or efficiently (such as the optimal method to manage memory allocation within the system)
3. Uncertainty concerning the appropriate design of the software – which includes anything from modifying the architecture of the graphics engine to rewriting an underlying algorithm.

Uncertainty is virtually everywhere in software development; most developers already account for such uncertainties in bug trackers. Uncertainty with regard to appropriate design is frequently demonstrated by the multitude of updates to code frequently tracked by most companies’ source version control, such as SVN, CVS, or Perforce.

Our video game developer experienced uncertainty in resolving several thread contention issues and memory leaks while developing their games. The developer also invested months of effort to conceptualize

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and design new player interaction schemas. Because they had uncertainty regarding the specific design of code that would solve the tread contention/memory leak issues, the company had the required uncertainty to qualify and pass this part of the test. Our client documented its uncertainties, which we reviewed and analyzed, in its source code committed to SVN.

Process of Experimentation. In an effort to eliminate any type of uncertainty, qualifying software companies must utilize their development process to systematically assess solutions and sometimes alternatives. Experimentation is practically inherent in software development workflows, such as the waterfall, agile, and scrum processes. These and other development methodologies are built on the same theme: developing an initial design and architecture as a hypothesis, building out functional and technical specifications, testing prototype code, evaluating the results to determine the source of any defects, and refactoring the code for optimal performance.

Our game developer followed variations of the scrum or waterfall programming process in several ongoing projects. Both of these development methodologies included steps that satisfied the experimentation requirement: each required software architects and designers to develop initial designs based on use case scenarios or other specifications, followed by an iterative testing process that required code refactoring to eliminate bugs prior to any release.

If I think what I do qualifies, how do I take the R&D credit?

If you have applied these four tests to your company and want to make a smart decision for your company, where do you go from here? First, go to your last federal tax return to see if your company is already claiming this credit. If you find Form 6765, you are already claiming the credit. If you don't see this form, talk to your tax advisors today. Whether that means your CPA, attorneys, or a specialty consulting firm, you can't afford to wait and miss out on any potential claims.

If you did find Form 6765 in your tax return, don't assume your work is over. The federal regulations that drive how the R&D tax credit is interpreted have changed significantly in the past few years. As is often the case, court decisions can help clarify ambiguities or guide taxpayers in interpreting the tax

code. Recent and pending court cases have affected the R&D tax credit significantly and have the potential to shift the rules for the software industry specifically. If you have not reviewed your research activities with your CPA or other advisor in a few years, it could pay to take a second look. Additionally, check to make sure you are also receiving the maximum R&D benefit for your state. Taking the time to ensure you are receiving everything to which you are entitled will pay off in peace of mind.

For those who are already claiming the credit and those who are about to call their advisors, make sure you claim everything that you are entitled to receive. Many companies make the mistake of restricting their claims to software engineering activities that represent only a portion of the qualified work in their development cycle. If this is true, you may be overlooking costs related to video game design, project management, or any testing that occurs in or out of your QA department.

Conclusion

If you are developing games or software, and you meet the four-part test described above, you need to investigate further to determine if you should be claiming the R&D tax credit. Talk to your CPA or advisor immediately (tax deadlines are always right around the corner). Regardless of how you choose to investigate this opportunity, keep in mind that assistance from an individual with a strong background in software engineering as well as tax law is invaluable. Many of the licensing agreements that exist between game companies for physics and graphics engines can be complex, and require individuals with experience in the game development industry to interpret them. Due to the inherent challenges in understanding the unique issues encountered by software developers and how the statute applies to them, many CPA firms choose to engage outside firms to ensure the R&D credit is calculated correctly. Finding the right advisor, one that has experienced software developers and attorneys on staff, helps ensure that you receive the maximum credit allowed by law. Whether your advisor helps to uncover costs associated with projects that you haven't identified in the past, like acceptance testing by specialized employees, to the alternative, of having the expertise to help you carve out ("shrink back") costs that may not qualify, the better your advisor knows your business, the better your chances for getting the full benefit of the credit.

The available federal and state R&D tax credits can represent a considerable financial boon to software developers in industries as diverse as arcade gaming, web applications, and even iPhone app development, so there is no time to waste in finding out how much you deserve.

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