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In this installment of Practically Speaking: Tax Controversy, the authors examine the IRS's audit efforts related to the research credit under section 41, what can be expected in that type of audit, and options for resolving one.

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In recent years, the IRS has increased its focus on section 41 research credit claims, leading to a rise in the number of examinations. The IRS Large Business and International Division announced a new campaign in 2017 specifically targeting the research credit. The IRS has also been relatively successful in recent years in litigating research credit cases. This article focuses on developments in the research credit area, including recent guidance and case law.

I. Background

Section 41 allows taxpayers a credit against tax for increasing research activities. Generally, under the traditional method of computation, the credit is 20 percent of the taxpayer's qualified research expenditures (QREs) for the tax year over a base amount.[1] QREs are the sum of three items: (1) the in-house research expenses paid to employees for the performance of qualified services; (2) the amount of supplies used in the conduct of qualified research; and (3) certain contract research expenses paid to third parties.[2] Qualified services include engaging in qualified research.[3] Qualified research activities must satisfy a four-part test composed of: (1) the permitted purpose test; (2) the technological in nature test; (3) the elimination of uncertainty test; and (4) the process of experimentation test.[4] If an activity satisfies these four tests, it will constitute qualified research unless it falls into one of eight excluded categories set forth in section 41(d)(4).

Section 41 was enacted to encourage research activities and promote business investments in

[1] An alternative simplified method is also available to calculate the research credit. Section 41(c)(4).

[2] Section 41(b)(1) and (2).

[3] Section 41(b)(2)(B).

[4] Section 41(d); reg. section 1.41-4.

technological research.[5] Neither the code nor the regulations require records in any particular form to substantiate the research credit. Rather, the taxpayer need only "retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit."[6]

II. Recent IRS Guidance

In recent years, the IRS has been issuing guidance to taxpayers regarding claiming and substantiating the research credit. Selected recent guidance is discussed below.

A. Research Credit Refund Claims

It is not uncommon for corporate taxpayers to need to amend their tax returns after filing. For the research credit, taxpayers may discover that they did not claim the full amount of the credit to which they were entitled and therefore seek to submit a refund claim, either through the filing of an amended return or through an adjustment at the beginning of an IRS audit. The IRS recently issued guidance regarding this situation.

On October 15, 2021, with the stated aim of managing research credit issues and resources more efficiently, the IRS issued FAA 20214101F. In that field attorney advice memorandum, the Office of Chief Counsel concluded that for research credit refund claims, to satisfy the specificity requirement of reg. section 301.6402-2, taxpayers must identify the following five items:

1. all the business components to which the research credit claim relates for that year, and for each business component a taxpayer must identify the information in items 2-4;
2. all research activities performed for each business component;
3. the names of all individuals who performed each research activity for each business component;
4. all information that each individual sought to discover; and
5. the total qualified employee wages, qualified supply expenses, and qualified contract research expenses (this requirement can be satisfied by completing Form 6765, "Credit for Increasing Research Activities").

The five items must be provided for all research credit refund claims postmarked on or after January 10, 2022. During an administrative transition period, the IRS will issue a letter to taxpayers for refund claims that the agency deems deficient under the standards of FAA 20214101F. Taxpayers have 45 days to reply to the letter to perfect the research credit refund claim before the IRS's final determination on the viability of the claim.[7] This administrative transition period has been extended to claims filed through January 10, 2025.[8] The extension of this administrative grace period is a welcome relief for taxpayers because if the IRS rejects a refund claim after the expiration of the statute of limitations, a taxpayer could lose its ability to file a perfected refund claim.[9]

Although the decisions predate FAA 20214101F, courts have addressed the specificity requirement under the per se rule set forth in reg. section 301.6402-3(a)(5) concerning refund claims based on the section 41 research credit. In *McFerrin*,[10] the district court rejected the government's argument under reg. section 301.6402-2(b)(1) that the taxpayer did not file a refund claim; it found that the Form 1040 explained the reason for the taxpayer's amended return and included a Form 6765, which reported the research credit.[11] Similarly, in *Premier Tech*,[12] the district court held that the taxpayer's amended return satisfied the specificity requirement and constituted a claim because it contained sufficient data to calculate the tax, and

[5] H.R. Rep. No. 97-201, at 111 (1981).

[6] Reg. section 1.41-4(d). Taxpayers and the IRS may agree to guidelines for the retention of specific records to substantiate the research credit. *Id.*

[7] IRS, "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions" (Dec. 14, 2023) (FAQs).

[8] *Id.*

[9] *See, e.g.*, *Computervision Corp. v. United States*, 445 F.3d 1355, 1371 (Fed. Cir. 2006) (noting that amendments to a refund claim can be filed after the statute of limitations has expired if the original claim is "still being considered by the IRS").

[10] *United States v. McFerrin*, 492 F. Supp. 2d 695 (S.D. Tex. 2007), *vacated and remanded*, 570 F.3d 672 (5th Cir. 2009).

[11] *Id.*, 570 F.3d at 705-706.

[12] *Premier Tech Inc. v. United States*, No. 2:20-cv-00890, at 8 (D. Utah July 15, 2021) (case pending discovery; bench trial scheduled for May 20, 2024).

included enough information to allow the IRS to efficiently investigate the requirements of section 41 and make an informed determination about the refund.[13] In reaching its conclusion, the court rejected the government's argument that the amended return was insufficient because the taxpayer did not attach additional documents addressing every single element in section 41.[14] However, in *Harper*, the district court dismissed the taxpayers' refund suit for lack of subject matter jurisdiction because their refund claims failed to meet the specificity requirements.[15] The taxpayers filed Forms 1040-X, attaching Forms 6765, claiming refunds stemming from research-credit-related adjustments, but they identified neither the business components that gave rise to the credit nor the employees who participated in the project.

Taxpayers should be wary of relying on *Premier Tech* to challenge any IRS determination that a refund claim is deficient because it did not include one or more of the five items. First, even if the IRS were to acquiesce to the decision, given the higher bar set forth in the district court's decision in *Harper*, one would expect that acquiescence to be limited to taxpayers within the same jurisdiction as *Premier Tech.* Moreover, much of the opinion in *Premier Tech* focuses on the fact that the taxpayer complied with the requirements set forth in the required IRS forms. As discussed in more detail below, the IRS has proposed revisions to Form 6765 to require taxpayers to provide the five items when filing a refund claim. This would make it easier for the IRS to distinguish *Premier Tech* in cases in which the refund claim was filed in 2023 or later because the updated Form 6765 instructions explicitly state that the five items must be provided when a research credit is claimed on an amended return. Thus, although burdensome, taxpayers should strive to comply with the requirements set forth in FAA 20214101F.

We have seen several instances in which taxpayers have received the initial letter from the IRS indicating that the original claim was deficient. Although the IRS stated that these letters would indicate which of the five items of information was missing,[16] often they just recite the five items and provide no explanation as to which of the five items was deemed to be missing. This, of course, can make it difficult to perfect the claim, especially within the 45-day perfection period. Nevertheless, our experience has been that when taxpayers reply to this notice with a more robust response addressing each of the five items, the IRS has not further challenged the validity of the claim. Still, the IRS is likely to reject claims, even after the taxpayer's attempt to perfect the claim, in situations in which the taxpayer has not provided all the information for each business component. For instance, we would expect the IRS to reject a claim in situations in which a taxpayer calculated its credit using a "judgment sample" and not a statistical sample performed in accordance with Rev. Proc. 2011-42, 2011-37 IRB 318, and the claim only provides information for those business components included in the judgment sample.[17] In October 2023 the IRS added FAQ 20, which is a best practice example for submission of the five items. Taxpayers should leverage this example when preparing initial claims and responding to the initial deficiency notifications.

B. Proposed Revisions to Form 6765

Focusing on FAA 20214101F, the IRS recently released proposed changes to certain sections of Form 6765[18]:

- *Updates to sections A and B*: The key change is moving the "reduced credit" election and the "member of a controlled group or business under common control" question from lines 17 and 34, respectively, and adding them to the top of the form.

[13] *Id.* at 5.

[14] *Id.* at 10.

[15] *Harper v. United States*, No. 3:18-cv-02110 (S.D. Cal. Apr. 25, 2019), *rev'd*, 847 Fed. Appx. 408 (9th Cir. 2021). The Ninth Circuit reversed because it found that the government had waived its right to enforce reg. section 301.6402-2(b)(1) by engaging in a substantive examination of the taxpayers' refund claims and issuing a final denial of those claims on the merits.

[16] FAQs, *supra* note 7, at FAQ7.

[17] See FAQs, *supra* note 7, at FAQ 18 for the stat sample inclusion requirements.

[18] IR-2023-173.

- *New section E*: There is a new line 48 for consistency requirements in the credit calculation.
- *New section F*: This section includes new lines 50 through 57, which require substantial information for each business component and essentially import the requirements set forth in FAA 20214101F.
- *Section F response options for lines 50(e) through 50(h)*: Guidance is provided on how to respond to certain questions in new line 50.

The IRS is considering making final changes to Form 6765 effective beginning with the 2024 tax year.

The scope and breadth of the proposed changes are not without controversy, particularly the request for all business components. Many taxpayers have hundreds or more business components in a claim year, and requiring the disclosure of each one would be extremely burdensome. Moreover, the requirement appears contradictory to the accepted practice of statistical sampling and Congress's intent to encourage investments in research.

Taxpayers and organizations have submitted comments highlighting potential issues with the proposed changes to Form 6765. For example, the American Institute of CPAs' detailed submission requested clarification on the proposed changes to section E, more focused modifications to the information requested in section F, and further clarifications and instructions related to sections E and F for taxpayers that use statistical sampling to determine QREs.[19] As it relates to section F, the comments call for the removal of requests for duplicative information and for limiting the number of business components required to complete lines 50-57 to the lesser of the top 10 total QRE-generating business components or the business components that represent 80 percent of total QREs.

It remains to be seen whether the IRS will make changes to the proposed revisions to Form 6765. Nevertheless, regardless of the changes made to Form 6765, there may ultimately be a benefit for taxpayers. Given the extensive information the IRS is now requiring for refund claims under FAA 20214101F and the approach in the proposed revisions to Form 6765, the IRS should adjust its examination techniques to account for the substantial amount of information provided by taxpayers when conducting an examination. And for taxpayers, the IRS's shift toward requiring more information brings to mind the oft-cited principle of the importance of maintaining an audit-ready file to lessen the burden during an examination.

C. The ASC 730 Directive

On September 11, 2017, the IRS issued a directive on allowance of the research credit for taxpayers that expense research and development expenses in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 730.[20] The ASC 730 directive applies to LB&I taxpayers that follow U.S. generally accepted accounting principles to prepare their certified audited financial statements and reflect the research expense amount either as a separate line item on the income statement or separately state the amount in a note to the financials. On September 10, 2020, the IRS revised and clarified the ASC 730 directive effective for tax years ending on or after July 31, 2020.[21] The revised directive allows LB&I agents to accept as sufficient evidence of QREs the adjusted ASC 730 financial statement research amount (that is, the amount reported on the audited financial statements subject to specified adjustments set forth in the ASC 730 directive). Taxpayers that follow the directive are required to complete appendices B and C, which form the basis of the calculation; sign a certification statement under penalties of perjury stating that they have complied with the directive; and retain and make available certain enumerated documentation that supports the amounts reported in appendices C and D. The directive was intended to reduce the burden on both taxpayers and the IRS. However, as discussed below, that hasn't always been the case.

[19] *See* AICPA, "Comments on Proposed Changes to Form 6765, Credit for Increasing Research Activities" (Oct. 30, 2023).

[20] LB&I-04-0917-005.

[21] LB&I-04-0820-0016.

III. What to Expect at Exam and Appeals

The goal of all taxpayers is to resolve examinations as quickly and efficiently as possible. The ability to resolve a research credit audit at the examination level versus the Independent Office of Appeals level presents different challenges and strategic choices for taxpayers.

A. Exam

As noted, in recent years the IRS has significantly increased its scrutiny of the research credit. In 2017 the IRS launched the "Research Issues" campaign. The stated goals of the campaign were "to promote voluntary compliance, focus resources on the highest risk research issues and increase consistency of examinations."[22] While research credit examinations were always resource-intensive, they have become more so.

For many years, the IRS has been requiring taxpayers to provide calculations and supporting data in a manner similar to what is required in FAA 20214101F and the proposed revisions to Form 6765 — that is, QREs by business component. This has been a shock to many taxpayers that may have prepared their study using a cost center or departmental approach,[23] or that had developed an informal agreement on a calculation method during prior examination cycles. This results in taxpayers effectively needing to recalculate their research credit during the examination. The passage of time often makes it difficult to locate subject matter experts within the organization who can assist. And the inability to reliably allocate QREs to a business component can lead to a disallowance of all or part of the research credit. Similarly, the IRS has been requiring a substantial amount of contemporaneous documentation to support time surveys, allocations of expenses, etc. Despite precedent to the contrary,[24] estimates of time spent performing qualified research activities or allocations of QREs based solely on the determination of a group manager, for example, are increasingly being challenged on examination. Thus, without contemporaneous documentation, taxpayers are at risk of having their research credit disallowed because of a lack of substantiation. With the IRS's substantiation win in *Little Sandy Coal*,[25] we can expect the agency to be even more insistent on receiving granular detail on a business-component-by-business-component basis.

Examinations of taxpayers that followed the directive have also been resource-intensive. Although billed as a way to efficiently examine research credits, the results have been mixed. Exam teams routinely ask for information not specifically enumerated in the directive. The directive states that this should be done only if the exam team determines that the requirements of the directive have not been met, and doing so requires approval from the territory manager. In effect, taxpayers may be in a position in which they are undergoing both a financial statement audit of the ASC 730 amount and an audit of their research credit as if they had not followed the directive. Not only does this result in time-demanding examinations but it also will likely result in a lower credit than the taxpayer could have claimed had it not followed the directive.

The adage, "the best defense is a good offense" has never been truer than with research credit examinations. As discussed above, without reliable contemporaneous documentation, there is a significant risk that the research credit could be disallowed because of a lack of substantiation. Consequently, to mitigate the risk that all or a portion of the credit will be disallowed on examination, taxpayers should prepare a

[22] IRS, "Large Business and International Active Campaigns" (as of Dec. 12, 2023).

[23] Notably, however, the IRS's audit techniques guide provides guidance on how to examine the research credit when taxpayers have taken a cost center or departmental approach. *See* IRS, "Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) Section 41," at section 2.d ("Determining the Scope").

[24] *See, e.g.*, *Suder v. Commissioner*, T.C. Memo. 2014-201 ("If a taxpayer can prove that its employees engaged in qualified services, the Court may estimate the expenses associated with those activities."). Citing the decision in *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), the Tax Court also stated, "The Court 'should look to testimony and other evidence, including institutional knowledge of employees, in determining a fair estimate,'" which only requires a reasonable basis. *Id.*

[25] *Little Sandy Coal Co. Inc. v. Commissioner*, T.C. Memo. 2021-15, *aff'd*, 62 F.4th 287 (7th Cir. 2023).

thorough research credit study shortly after the tax year ends or consider a prefiling agreement (PFA) (discussed *infra*) to get certainty on their research tax credit.

B. Appeals

The mission of Appeals "is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service."[26] In research credit matters, Appeals frequently uses the services of a technical specialist such as an engineer to assist in understanding the issues and determining an appropriate settlement.

As noted, research credit matters can be highly fact-sensitive. Increasingly, exam teams have been disallowing claims in their entirety based on allegations of lack of substantiation. Moreover, recent experience indicates that Appeals is relying more heavily on specialists in formulating settlement offers. As a result, these cases reflect the difficulty of obtaining full or close-to-full concessions at the Appeals level in even the strongest research credit matters.

IV. ADR Options

The IRS offers taxpayers set options for alternative dispute resolution (ADR) to resolve their disputes.[27] In May 2023 a Government Accountability Office report set forth findings of the IRS's ADR programs and made several recommendations.[28] The IRS took note of the GAO report. It has been requesting comments on its ADR programs and stating that new ADR solutions may be available in early 2024.[29]

Three potential ADR options for taxpayers with research credit matters are: (1) PFAs; (2) the industry issue resolution program; and (3) fast-track settlement (FTS). The first two are listed as prefiling or pre-audit resolution options, while the third is a case resolution option. In recent conferences and meetings in which we have been present, IRS officials have specifically mentioned these three options as suitable for resolving research credit matters.

A PFA, although costly ($181,500 for a taxpayer selected to participate), is a mechanism that can provide certainty for taxpayers for the year of application and up to four future years.[30] The purpose of a PFA is to resolve, before the filing of the tax return, a matter involving factual issues that fall under well-settled tax law principles. For large research credit issues, taxpayers may want to consider seeking a PFA to avoid the time and cost of a potentially extensive and intrusive examination and to achieve finality for several years. PFAs have been successfully used by several taxpayers in the past on research credit matters.

IIRs are an industry-level form of ADR as opposed to a taxpayer-specific form of ADR.[31] They may be used when there is a burdensome tax issue with uncertain tax treatment that affects a substantial number of taxpayers, resulting in frequent, often repetitive examinations. Pursuing an IIR generally requires support from the industry involving a specific issue. Although an IIR is used significantly less than other ADR options, it has been used in the past in the research space; in 2017 the IRS issued the ASC 730 directive as a result of the IIR process.

FTS was first introduced in 2001 as a pilot program for LB&I taxpayers, and it has since been expanded to include certain other taxpayers. As its name suggests, FTS is an ADR tool designed to resolve disputes quickly — within 120 days — by using mediation techniques of an Appeals officer and delegating hazards of litigation to exam teams.

FTS was popular for many years; however, it and certain other ADR options have declined in use over the past decade. The GAO report

[26] Internal Revenue Manual 8.1.1.1(1).

[27] *See* IRS, "Dispute Prevention and Resolution for Large Business and International Taxpayers" (July 7, 2023) (providing details of prefiling/pre-audit resolution and post-filing/case resolution types of programs).

[28] *See* GAO, "IRS Could Better Manage Dispute Resolution Programs to Maximize Benefits," GAO-23-105552 (May 2023); *see also* Sharon Katz-Pearlman, "The Long and Winding Road to Resolution — Can ADR Shorten the Distance?" *Tax Notes Int'l*, Aug. 21, 2023, p. 941.

[29] *See* Jonathan Curry, "IRS Appeals Prepping 'Creative' New Dispute Resolution Tools," *Tax Notes Federal*, Nov. 20, 2023, p. 1505.

[30] Rev. Proc. 2016-30, 2016-21 IRB 981, and the IRS's website provide more details on PFAs.

[31] Rev. Proc. 2016-19, 2016-17 IRB 497, and the IRS's website provide more details on IIRs.

attributed the decline to the belief among taxpayers that the IRS did not always participate in ADR programs in good faith to move from a position, taxpayer confusion about how ADR programs work, and the blocking of a settlement by a mediator. In light of the GAO report, there is optimism that the IRS will refocus its efforts on ADR programs such as FTS to deal with burdensome workloads and backlogs.

FTS has been used in many research credit matters to avoid the time and expense of the prolonged and more costly Appeals (and potentially litigation) process. FTS is designed for the parties to reach a compromise; thus, taxpayers must be willing to make some type of concession and should engage in proactive discussions with their exam teams before requesting FTS to ensure that a settlement is realistic and acceptable.

V. Conclusion

Examinations of claimed research credits, whether on original or amended tax returns, continue to be an area of heightened scrutiny and enforcement by the IRS. Between increased reporting requirements and recent judicial developments, it is even more important now to ensure that proper documentation is created and maintained to support the claimed credits if selected for examination. In reaching certainty in and protecting their research claims, taxpayers may want to consider various available ADR options and should seek to be proactive in this area.[32] ■

[32]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG LLP.