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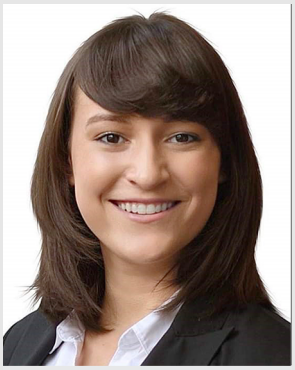

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In this installment of Practically Speaking: Tax Controversy, the authors revisit the IRS's audit efforts concerning the section 41 research credit; examine recent developments in case law, updates to Form 6765, and new refund requirements; explain what to expect during these audits; and provide effective strategies for resolution in light of the latest regulatory changes.

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I. Introduction

In the rapidly changing landscape of the section 41 research credit, staying updated is essential for both taxpayers and practitioners. In a previous article[1] we highlighted the IRS's increased scrutiny of research credit claims. Since then, there have been revisions to Form 6765 that added reporting requirements, new IRS guidance concerning research credit refund claims, and relevant judicial guidance. This article explores those developments and offers practical insights to help taxpayers and practitioners navigate the complexities of section 41 research credit claims.

II. Background

Section 41 seeks to stimulate business investment in technological innovation by providing taxpayers with a credit against tax for increasing research activities. Under the

[1] *See* Andrew R. Roberson, Justin Donatello, and Rachael Moore, "Navigating the Shifting Landscape of Research Credit Audits," *Tax Notes Federal*, Jan. 22, 2024, p. 667.

traditional method of computation, the credit is generally 20 percent of the taxpayer's qualified research expenditures (QREs) for the tax year that exceed a base amount.[2] QREs are made up of three main components: (1) in-house research expenses paid to employees for performing qualified services, (2) the cost of supplies used in conducting qualified research, and (3) certain contract research expenses paid to third parties.[3] Qualified services involve engaging in research activities that meet a four-part standard made up 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]

Activities that satisfy these criteria are considered qualified research unless they fall into one of eight excluded categories: (1) research after commercial production; (2) adaptation of existing business components; (3) duplication of existing business components; (4) surveys, studies, etc.; (5) internal-use computer software (except to the extent provided in the regulations); (6) foreign research; (7) social sciences, etc.; and (8) funded research.[5]

As explained below, the Tax Court is now considering the funded research exclusion. Moreover, the computer software exclusion — which focuses on whether software is internal-use software — can be a highly contentious area during examination.[6]

Enacted to foster research activities, section 41 does not mandate specific forms of recordkeeping to substantiate the research credit.[7] Instead, taxpayers are required to "retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit."[8] Understanding these foundational aspects remains crucial in 2025, especially in light of recent regulatory updates and case law developments that may affect compliance and audit strategies.

III. 2024 Developments

In 2024 the IRS updated the requirements for research credit refund claims and released an updated Form 6765, "Credit for Increasing Research Activities." The courts also gave us guidance on the research credit, including in the substantiation and funded research exclusion areas.

A. Research Credit Refund Claims

Corporate taxpayers often need to amend their tax returns, particularly when they realize they have not claimed the full amount of the research credit to which they are entitled. This can lead to refund claims, either through the filing of an amended return or through an affirmative adjustment at the start of an IRS audit during the 30-day disclosure period. In an earlier response to the influx of refund claims involving the research credit, the IRS released FAA 20214101F in October 2021. This field attorney advice, which was not published in the Internal Revenue Bulletin and was met with criticism by some commentators,[9] said taxpayers must provide the following information to satisfy the specificity requirement of reg. section 301.6402-2 for research credit refund claims:

- all business components concerning the research credit claim for that year, and for each component;
- all research activities performed;
- the names of all individuals who performed each research activity;
- all information each individual sought to discover; and
- the total qualified employee wages, qualified supply expenses, and qualified

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

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

[4] Section 41(b)(2)(B); section 41(d); reg. section 1.41-4.

[5] Section 41(d)(4).

[6] If the IRS believes the claimed research credit contains internal-use software QREs, it generally will make a referral to the MITRE Corp. IRM 4.48.1.2. MITRE's website says that "as an independent, leading technology and research and development company, MITRE serves as a trusted national resource." MITRE, "R&D Centers" (last visited Feb. 11, 2025).

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

[8] 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).

[9] *See, e.g.*, Mary Katherine Browne, "IRS Extends Grace Period for Perfecting Research Credit Claims," *Tax Notes Federal*, Dec. 2, 2024, p. 1863; Kristen A. Parillo, "IRS Makes Seismic Shift on How to Claim Research Credit Refunds," *Tax Notes Federal*, Oct. 25, 2021, p. 565.

contract research expenses, typically provided via Form 6765.

According to the IRS, these requirements apply to all research credit refund claims postmarked on or after January 10, 2022. During an administrative transition period, the IRS issues a letter for claims deemed deficient, allowing taxpayers 45 days to correct their claims.[10] This period has been extended to claims filed through January 10, 2026, providing relief to taxpayers concerned about the statute of limitations for refund claims.[11]

On June 18, 2024, the IRS added question 21 to its list of section 41 frequently asked questions,[12] announcing that it would waive two requirements found in FAA 20214101F: (1) the names of the individuals who performed each research activity and (2) the information each individual sought to discover. That change applies to research credit claims postmarked June 18, 2024, and onward, although these items may still be requested during audits.

In practice, taxpayers have received IRS letters indicating deficiencies in their original claims. Although these letters are meant to specify missing items,[13] they often implicate all five requirements without specification. Despite the vague notice, a comprehensive response addressing each requirement has generally led to successful claim validation. However, claims lacking complete information for each business component, such as those using nonstatistical sampling methods in accordance with Rev. Proc. 2011-42, 2011-37 IRB 318, in which the claim only provides information for those business components included in the judgment sample, may still face rejection.[14] In October 2023 the IRS added question 20, providing a best practice example for submitting the required information. Taxpayers should use this example to prepare initial claims and respond to deficiency notifications effectively.[15]

B. Revisions to Form 6765

On June 21, 2024, the IRS announced a new draft Form 6765 effective for the 2025 tax year.[16] It includes fewer additional reporting requirements than were originally contemplated. The IRS said it incorporated feedback from stakeholders to streamline reporting and reduce taxpayer burden.[17] On December 12, 2024, the IRS released another draft Form 6765 with significant updates, including the addition of three new sections.[18] On December 20, 2024, the IRS released additional draft instructions for Form 6765.[19] On February 13, 2025, the IRS released the final Form 6765, making no additional changes. The new sections in the finalized form are:

- Section E: This section is now required for the 2024 tax year and includes information on business components, officers' wages as QREs, and check-the-box questions concerning new QRE sources, major business changes, and if the Large Business & International Division's Accounting Standard Codification Topic 730 R&D tax credit directive[20] was leveraged.
- Section F: This section breaks down qualified research expenses by type, such as wages and supplies, aligning with the initial proposals.
- Section G: Labeled section F in earlier drafts, it is optional for the 2024 tax year and will be mandatory for 2025. It requests detailed information by business component but has been significantly streamlined to reduce the reporting burden.

Taxpayers are required to report 80 percent of total QREs in descending order by business component, but no more than 50 components. The IRS highlighted that this change addresses

[10] IRS, "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions" Frequently Asked Questions (last updated Sept. 11, 2024).

[11] *Id.*

[12] *Id.* at question 21.

[13] *Id.* at question 7.

[14] *See id.* at question 18 for the statistic sample inclusion requirements.

[15] *Id.* at question 20.

[16] The IRS previously released proposed changes to Form 6765 following the issuance of FAA 20214101F. *See* IR-2023-173.

[17] IR-2024-171.

[18] Form 6765 (rev. Dec. 2024).

[19] IR-2024-313.

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

taxpayer and practitioner concerns about the burden of reporting hundreds of business components and aligns with the feedback received from stakeholders.

Further, section G reporting is optional for qualified small business taxpayers and those with total QREs of $1.5 million or less and gross receipts of $50 million or less claiming a research credit on an originally filed return.

These updates reflect the IRS's continued focus on substantiation. The agency estimates that completing the form will take a total of 17.75 hours, broken down into the following increments: 10.5 hours for recordkeeping, 2.25 hours for learning the law, and five hours to prepare the form.[21] While the IRS said these updates were focused on reducing taxpayer burden while maintaining the integrity of the information required for tax administration, the changes still represent a significantly higher hurdle to claiming research credits than in years past, as demonstrated by the estimated taxpayer burden.[22]

As these changes take effect, taxpayers should ensure that they are familiar with the new requirements and prepare accordingly for the upcoming tax years. Because these updates require additional information to substantiate research credit claims, it is important to reinforce the need to maintain detailed documentation of all research and development activities.

C. Tax Court Update

In 2024 the Tax Court issued opinions and orders providing insights into the interpretation and application of sections 41 and 174.[23] This judicial guidance discussed issues such as limitations on discovery, substantiation requirements, the scope of associated R&D expenses, and funded research.

1. *Kapur*.

In *Kapur*,[24] the Tax Court underscored the importance of comprehensive documentation when claiming the research credit. The court rejected the taxpayer's attempt to limit discovery to the largest projects from a statistical sampling frame. Instead, the IRS's request for preliminary information on all projects was deemed necessary to select a representative sample. This decision highlights the Tax Court's endorsement of the IRS's expanded documentation requirements, reinforcing the necessity for taxpayers to establish a clear and agreed-on sampling method with the IRS.

2. *Phoenix Design Group*.

In *Phoenix Design Group*,[25] the Tax Court affirmed the IRS's denial of research tax credits to an engineering consulting firm for three sample projects because of insufficient substantiation regarding the process of experimentation.[26] The court emphasized the need for explicit identification of unknowns at the project's outset and a clear demonstration of an evaluative process akin to the scientific method. In particular, the process of performing calculations and communicating results to the architects was not deemed an evaluative process comparable to the scientific method. Moreover, the inconsistencies in timesheet entries and the lack of objective uncertainty regarding the design weakened the taxpayer's claim.

This decision is unlikely to have a significant effect on research credit claims at large, and even less on taxpayers outside the engineering industry. That said, the opinion reiterates the critical importance of meticulous documentation and a well-defined experimentation process in both theory and practice. Taxpayers must ensure that their records clearly show what was

[21] Instructions for Form 6765 (rev. Jan. 2025).

[22] IR-2024-171.

[23] Federal appellate courts also addressed the research credit in 2024. The Fourth Circuit, in *United Therapeutics Corp. v. Commissioner*, 105 F.4th 183 (4th Cir. 2024), addressed the interplay between the section 41 research credit and the section 45C orphan drug credit. The Seventh Circuit, in a three-page opinion in *Moore v. Commissioner*, 101 F.4th 509 (7th Cir. 2024), affirmed the Tax Court's opinion that the taxpayers failed to substantiate that the taxpayer-husband's salary and bonus constituted qualified research expenses. Finally, the Eighth Circuit, in *Meyer Borgman & Johnson Inc. v. Commissioner*, 100 F.4th 986 (8th Cir. 2024), affirmed the Tax Court's opinion that the taxpayer's research was funded because its contracts lacked the express terms that courts have identified as important to establish payment was contingent on the success of the research.

[24] *Kapur v. Commissioner*, T.C. Memo. 2024-28.

[25] *Phoenix Design Group Inc. v. Commissioner*, T.C. Memo. 2024-113.

[26] The Tax Court said its conclusions regarding the three projects were not binding on the remaining projects but that it expected that its findings would enable the parties to mutually resolve the credits for the remaining projects.

unknown and required research, adhering to the scientific method to substantiate their R&D claims effectively.

3. *Intermountain Electronics*.

In *Intermountain Electronics*,[27] the Tax Court addressed the inclusion of production expenses in the numerator of the "substantially all" equation for research credits. The court said that production workers directly supporting qualified research could be considered directly engaged in qualified research. This decision suggests a willingness to reevaluate the precedent set by *Little Sandy Coal*,[28] potentially reaffirming the statute that defines what qualifies as R&D activity and the associated expenses and that direct support and direct supervision could be considered as "incident to the development or improvement of a product."[29]

4. *System Technologies*.

In *System Technologies*,[30] the Tax Court addressed the issue of "funded research" under section 41(d)(4)(H). The IRS submitted a motion for partial summary judgment, arguing that Systems Technologies Inc.'s research was funded because its contracts did not explicitly condition payment on successful research outcomes. Although explicit conditions regarding successful research outcomes were absent, the contracts contained an Indiana choice of law provision. This provision required Systems Technologies to refund payments to customers if it failed to deliver the product. Thus, the court denied the motion for partial summary judgment, emphasizing that under Indiana law, which governs these contracts, payment is indeed contingent on successful research.

5. *Smith*.

In *Smith*,[31] the Tax Court examined whether research conducted for several architectural projects was funded research under section 41(d)(4)(H). The IRS argued that the research was funded because the contracts did not condition payment on the success of the research and the taxpayer did not retain substantial rights in the research. Upon examining the various project contracts, the court identified factual disputes concerning the interpretation of the contracts and the application of foreign law regarding the retention of substantial rights in the research. The court observed that the taxpayer retained some rights in its research and that payment terms were linked to the completion of design milestones, which could suggest that payment was conditioned on successful research outcomes. The court therefore denied the IRS's motion for summary judgment because it was not appropriate to review the necessary factual elements to determine whether the research qualified as funded research at the summary judgment stage.

6. *CHA Holdings*.

Although a stipulated decision was reached in *CHA Holdings*,[32] the case is noteworthy because the parties were contemplating summary judgment motions regarding the effect of *Loper Bright*[33] on research credit regulations. Before settlement, the Tax Court had set a briefing schedule and asked the parties to address whether the dispute was over the interpretation or validity of the regulations and to consider addressing questions of *stare decisis*, the effects of specific grants or regulatory authority to the IRS on whatever deference is owed to tax regulations after *Loper Bright*, and what deference would be owed to the regulation at issue in the case — that is, what deference would look like under *Skidmore*.[34] It remains to be seen whether, in the new *Loper Bright* world, another taxpayer will challenge research credit regulations.

7. Implications for future claims and IRS examinations.

These Tax Court cases and the IRS's changes to Form 6765 may affect future research credit

[27] Order, *Intermountain Electronics Inc. v. Commissioner*, No. 11019-19 (T.C. Mar. 14, 2024).

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

[29] Reg. section 1.174-2(a)(1).

[30] Order, *System Technologies Inc. v. Commissioner*, No. 12211-21 (T.C. Aug. 1, 2024).

[31] Order, *Smith v. Commissioner*, Nos. 13382-17, 13385-17, 13387-17 (T.C. Dec. 18, 2024).

[32] *CHA Holdings Inc. v. Commissioner*, No. 27453-21 (T.C. Oct. 15, 2024) (stipulated decision).

[33] *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369 (2024).

[34] *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

claims and IRS examinations in several ways. First, the stringent documentation requirements will likely lead to more detailed and comprehensive recordkeeping by taxpayers. The need to establish clear methods and maintain meticulous records cannot be overstated, since failure to do so could result in disallowed claims.

Second, the enhanced scrutiny of the experimentation process and the technical uncertainty requirement signal a shift toward a more nuanced interpretation of R&D activities. Taxpayers must be prepared to demonstrate the scientific basis of their R&D activities, ensuring that their processes align with the rigorous standards set forth by the Tax Court and expected by the IRS. This may involve revisiting their internal documentation practices and ensuring that all experimentation activities are thoroughly documented and substantiated.

Third, the recent Tax Court cases underscore the importance of understanding how contractual terms and applicable state and international laws can affect the determination of whether research is considered funded in both the financial burden and the retention of rights contexts. To avoid any misinterpretation, taxpayers should be sure their contracts clearly articulate the conditions under which payments are made, particularly emphasizing any contingencies tied to successful research outcomes and the retention of rights in the research.

Finally, these rulings may influence the IRS's approach to audits, potentially leading to more rigorous examinations and higher compliance burdens. Taxpayers should anticipate increased demand for documentation and be prepared to defend their R&D claims with robust evidence. Even though the potential to include post-production expenses in research credit calculations has been contemplated by the Tax Court, it also could result in more comprehensive audits, obviating the need for taxpayers to be precise in their recordkeeping practices.

Taxpayers must continue to adapt to new IRS guidance and judicial developments to ensure that their documentation and substantiation practices are sufficient. By doing so, they can mitigate the risk of disallowed claims and navigate the complexities of future IRS audits with greater confidence.

IV. Observations From the Trenches

The section 41 research credit has been a hot IRS examination area for many years. Our recent experiences have varied, but we do have some general observations.

In our experience, IRS examination teams are disallowing research credit claims more often than in the past. One of the drivers for this appears to stem from cases such as *Little Sandy Coal* and the emphasis placed on substantiation. It is safe to say that, as a general matter, the IRS and taxpayers diverge on what constitutes sufficient substantiation. Interestingly, we have also seen information document requests, issued before any substantive work has been done on the claims, requesting how an estimate of the research credit can be performed under the so-called *Cohan* rule.[35] Overall, we are seeing the number of complete disallowances of research credit claims increase.

In some cases, we have seen only one or two information document requests with little to no follow-up for several months before the taxpayer is informed of a proposed adjustment. Similarly, we have experienced turnover among engineers, which can lead to essentially restarting the research credit portion of the examination. Based on this, we make sure that our regular updates with exam teams include a status update of any research credit matters to avoid surprises. When appropriate, taxpayers and practitioners may need to be proactive with IRS engineers to ensure that they have all the information necessary to confirm the validity of the research credit claim.

Over the last year, discussions about statistical sampling in relation to research credits have continued with exam teams largely because of *Little Sandy Coal*. For many taxpayers, statistical sampling, as outlined in Rev. Proc. 2011-42, serves as a dependable qualitative and quantitative approach to alleviate the burdens on both themselves and IRS examiners regarding research credits. Through statistical sampling, taxpayers identify QREs from a selected sample of items and

[35]Under *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), a court in a section 41 case can look to testimony and other evidence, including the institutional knowledge of employees, in making a fair estimate of items associated with the research credit. *See, e.g.*, *Suder v. Commissioner*, T.C. Memo. 2014-201, at *56.

then extrapolate these findings to the entire population. Because most taxpayers lack project tracking systems that can pinpoint all projects undertaken within a year to define the population, they often explore alternative methods to determine the sampling population and define the sampling unit. Without this information, taxpayers might consider using a department, cost center, or employee-based statistical sampling method. However, these approaches can make it difficult for taxpayers to demonstrate compliance with the "substantially all"[36] requirement of the business component test, especially when a single person, department, or cost center may not have full visibility into the entire business component.

At the issue resolution stage, we have seen taxpayers successfully resolve research credit disputes through the fast-track settlement process. Favorable outcomes have mostly been in cases in which the parties have been transparent regarding their view of the hazards of the issue and active in trying to resolve any factual disputes. We anticipate that more taxpayers will take advantage of the fast-track settlement process given changes announced in January 2025, including allowing fast-track settlement to be used for one or more issues (as opposed to all issues) and an explanation to the taxpayer when a fast-track settlement request is denied.

At the IRS Appeals level, we continue to see reliance on Appeals specialists who are engineers. This can be a welcome development when the specialist may be knowledgeable on a specific issue. However, it can cut the other way when an area or issue may not have been fully developed or advanced by the examination team and the Appeals specialist wants to explore that area. If that occurs, it is important to make sure Appeals is aware of how the issue was framed and reviewed by the examination team to avoid diverging from what was actually disallowed.

V. Conclusion

As we advance into 2025, the landscape of section 41 research credit claims continues to evolve. Recent changes to Form 6765 and the waiver of certain refund claim requirements reflect the IRS's efforts to streamline processes while maintaining, or even increasing, rigorous standards for substantiation. The agency's intensified focus on research credit audits, coupled with evolving case law, underscore the necessity for taxpayers and practitioners to stay informed and adaptable. In this dynamic regulatory environment, proactive engagement with IRS processes and a thorough understanding of the latest guidance are essential for ensuring compliance and optimizing research credit claims. Leveraging expert advice and maintaining robust records will be key to successfully managing the complexities of the research credit landscape in 2025 and beyond.[37] ■

[36]Reg. section 1.41-4(a)(6).

[37]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.