

IRS Keeps Focus on R&D Tax Credit Even as Agency Staff Shrinks

By Hogan Humphries, Alexander Fox, and Greg Sweigart

The Credit for Increasing Research Activities, known as the R&D credit, was established to encourage research spending in the US. And it will remain a priority for the IRS, even after the tax agency grapples with a significant reduction in force.

The R&D credit's enforcement has been undergoing changes. Some of them are detailed in the IRS Office of Chief Counsel's memo regarding R&D credit refund claims, subsequent updates to the refund claim procedures via the IRS Refund Claim FAQs page, and changes to the Form 6765, which is used to calculate the R&D credit.

Those developments, coupled with the recent structural changes within the IRS, have created challenges of which taxpayers should be aware. Below is a high-level overview of current trends and challenges in IRS examinations related to the R&D credit that underscore the continued need for robust studies.

IRS Examination Focus

The IRS continues to focus on areas with significant financial impact and complex facts, particularly R&D credits, transfer pricing, and clean energy credits. These areas remain attractive exam targets because even with staff reductions, the potential for substantial adjustments and revenue recovery is high.

The IRS views these as high-risk areas where aggressive tax positions are common. It's crucial to have strong documentation and well-reasoned positions supporting R&D credit claims. That includes traceability between research initiatives and the research expenses claimed, and technical documentation to substantiate the testimony of researchers.

Additionally, software development is seeing heightened scrutiny, especially within the financial services industry such as banks and investment management firms. This focus may stem from a

disconnect between the IRS's examination approach and the industry's rapid, iterative agile development processes.

For example, a modern software development life cycle often involves short sprints—typically two to four weeks—that include design, coding, and testing. The results of each sprint determine the scope of work for subsequent sprints. Such a short software development life cycle can complicate the evaluation of the process of experimentation required for the R&D credit.

IRS Workforce Reductions

Significant staff losses, particularly within the Large Business & International division, generally have created a bottleneck in the appeals process, leading to delayed case assignments and slower resolutions.

To manage this backlog and expedite outcomes, the IRS is increasingly promoting alternative dispute resolution tools, with a notable emphasis on fast-track settlements, which are detailed in two documents: [Dispute Prevention and Resolution Options: Postfiling Update](#) and [Update to prefiling agreement program](#). The alternate dispute resolution programs have numerous benefits, including faster resolution and lower costs.

Burden of Proof

Companies should be intentional and avoid aggressive tax positions when claiming the R&D credit, such as claiming credits for unsubstantiated activities. The IRS is likely to scrutinize these claims, especially for large and public companies.

Taxpayers may find that they face a higher burden of proof, as some exam teams are showing less willingness to rely on inferences to connect project activities to the process of experimentation. Exam teams are increasingly requiring more direct substantiation, such as documentation that proves every aspect of the research process for a particular project, or individuals with a comprehensive understanding of entire research projects.

It's important to have robust documentation and consult with reputable tax professionals to ensure

compliance and minimize audit risk. The IRS isn't likely to go "light" on these longstanding audit targets.

R&D Expertise Needed

While the number of specialized IRS examiners may shrink, deep expertise in areas like the R&D credit and transfer pricing remains essential for the agency. Therefore, it's unlikely that specialization will disappear entirely.

The IRS will continue to need examiners with the skills to understand complex technical and financial details to effectively examine these claims.

Leadership, Budget Changes

Uncertainty surrounding IRS leadership and future budget allocations can influence audit priorities and resource allocation. While the specific direction may depend on future appointments and funding levels, the IRS is expected to continue focusing on high-value credits like the R&D credit due to the financial stakes involved.

Complexity and risk will remain central to IRS exam decisions. While the uncertainty around future budgets may affect IRS exam capacity and resource allocation, the R&D credit remains a top area of focus for the IRS.

Though these changes have created a more complex audit environment, taxpayers claiming the R&D credit shouldn't be discouraged. Instead, taxpayers should ensure they are detailed and organized with their substantiation and understand the importance of technical documentation illustrating their research activities and expenditures.

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