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Annual Conference Scottsdale, AZ

**Navigating IRS Requests
for Increased
Transparency in Research
Credit Positions**

Monday, October 24, 2022

5-6PM



Moderator



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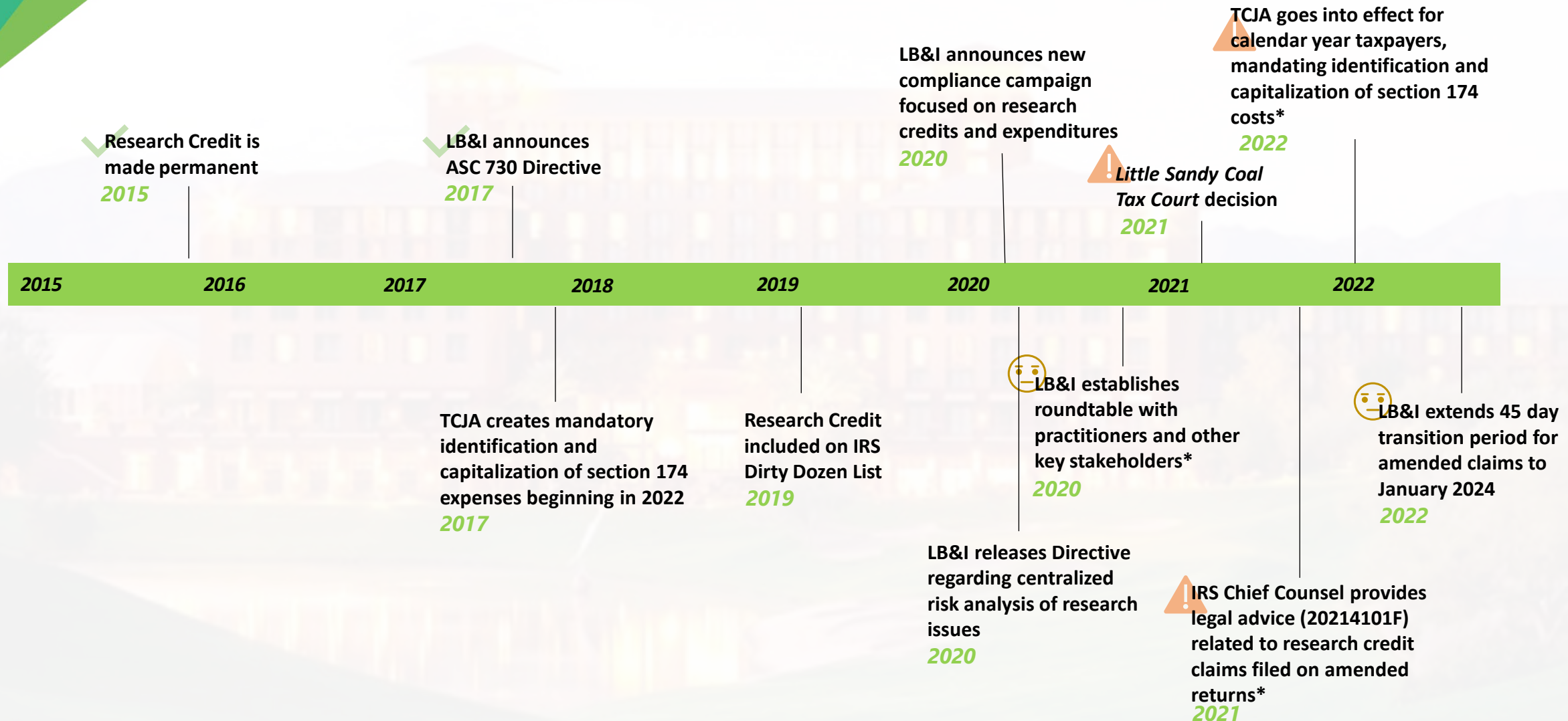
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Agenda

- Recent R&D Developments – IRS National Office and TCJA
- Examination Trends and Suggested Strategies
- Preparing for Appeals
- Best Practices for Taxpayers



**Discussed in detail on subsequent slides*

LB&I Roundtable Sessions

November 2020

- Inform IRS risk assessment for improved selection/deselection of issues
- Efficiencies in IRS examination
- Improving certainty for taxpayers and tax administration

May 2021

- LB&I sets goals for roundtable
- Current efforts underway
- Improving risk analysis

May 2022*

- Research credit claims validity
- Form 6765 updates
- Statistical sampling

Chief Counsel Memorandum (20214101F) Update

- 100% of claims submitted since January 10, 2022 have been rejected because taxpayers did not include additional information requested under the CCM
- IRS trying to “identify risk and deselect inventory”
- The CCM is asking for “basic things expected by the law”
- Reiterate need for business component support
 - New(er) focus on quantitative, continued focus on qualitative and contemporaneous documentation

Proposed 6765 Form Changes (2023 Tax Year)

- List of *all* business components and associated QREs
- Did the taxpayer identify new qualifying activities?
- Is the taxpayer following ASC 730 Directive?
- Did the taxpayer use statistical sampling?
- Others:
 - Member of control group? List other entities and PBA code
 - Total wages reported on Form 1125-E
 - Did the taxpayer acquire/dispose of business?

Statistical Sampling

- Best practice to identify sampling using business components (not employees)
- Suggested update of Audit Techniques Guide for statistical sampling to identify “external or internal” sample
- Oral testimony should be “filling the potholes, not paving the road”

Tax Cuts and Jobs Act (TCJA) of 2017

- TCJA requires capitalization of all section 174 research and experimental expenditures, including software development costs, incurred in tax years beginning after Dec. 31, 2021
- Capitalized section 174 costs will be deductible over 5 (domestic) or 15 (non-US) years
 - Notable change in tax policy; taxpayers have been able to choose to deduct research and experimental expenditures as incurred since 1954
 - Departure from GAAP, which normally requires immediate expensing of research expenditures under ASC 730

Why Does This Matter?

- IRS is doubling down:
 - Additional resources (many are “technical” / back office)
 - Internal training
 - Focus on business components
 - Shrink-back
 - Audit trail of project list
 - Contemporaneous documentation that “should already exist” and supports qualifying business components
 - Form changes / more upfront information
 - New questions around Section 41 v. Section 174 ratio / relationship

IRS Audits – IDR Trends

- The IRS is becoming increasingly aggressive in challenging research credit claims on original returns as well
- That aggressiveness takes several forms:
 - Looking for “silver bullets” to disallow claims without examining them in detail
 - For example, rejecting sampling methodologies

IRS Audits – IDR Trends

- Asking only a single very broad IDR question seeking a description of qualifying work, and then moving directly to issuing on a NOPA, often on the basis that the taxpayer has not produced sufficient records to supports its claim, even though no IDR requested such documents
 - In those instances, many Exam Teams provide an Acknowledgment of Facts IDR with only a broad, vague factual description and indicate that the taxpayer must provide any additional information on which it wishes to rely.
 - In essence, the IRS is saying that a taxpayer must volunteer anything it thinks could be relevant without a specific question.
 - This places an intolerable burden on taxpayers to guess what an Exam Team thinks might be an issue.

IRS Audits – IDR Trends

- These premature NOPAs often seem to have a cookie-cutter aspect to them, as we have seen several with identical language and one that made arguments clearly not applicable in the given case.
- IRS managers have indicated no concern with this approach, stating that it is up to the taxpayer to produce the materials to prove its case.
- The IRS sometimes declines offers for interviews, plant tours, or presentations, leaving the “record” devoid of helpful factual information on which the taxpayer can rely.
- The IRS also frequently criticizes taxpayers’ documentation because the engineering materials do not neatly set forth satisfaction of the elements of the 4-Part Test.

IRS Audits – IDR Trends

- Where the IRS does seek to develop the record, it asks broad questions that are burdensome to answer:
 - Requests for supporting workpapers establishing that the 80% “substantially all” test is satisfied;
 - Requests for a description of how qualifying percentages were determined;
 - Requests for general ledger account information and the contracts covered by each account;
 - Requests to associate each employee’s time with the business components on which she worked;

IRS Audits – IDR Trends

- Requests for the taxpayer to identify all business components and contracts even where it relied on sampling;
- Requests for information regarding employees conducting research activities or being paid directly under contract, including:
 - Technical background information;
 - Performance reviews and achievements;
 - R&D activities performed;
 - Use of particular supplies or tooling.

IRS Audits – IDR Trends

- Breakdown into Business Components for:
 - General Ledger Accounts;
 - Contracts;
 - Qualifying percentage calculations.
- Broad qualitative questions

IRS Audits – IDR Trends

- Broad Questions: Examples

With respect to each fixed price contract for which the taxpayer claimed QREs in connection with the Sample Units, please produce the following:

- a. Describe, discuss, or identify the separate and discrete business component(s) developed under each contract.
- b. Describe or discuss the uncertainty (ies) concerning the development or improvement of each business component identified in response to Item a.
- c. Describe or discuss one or more identified alternatives intended to eliminate the uncertainty (ies) concerning the development or improvement of each business component.
- d. Describe, discuss, or identify the manner or method the taxpayer used to record the results of the evaluations or tests performed to develop each business component.

IRS Audits – IDR Trends

- Broad Questions: Examples

For each of the sample units with non-zero QREs in the sample for contract research, please provide:

- a. A detailed information on each general ledger account for each cost center.
- b. An estimate of how many contracts are covered by each account in each cost center.
- c. A detailed explanation of how the qualifying percentages in the sample unit for each general ledger account in each cost center were determined.

IRS Audits – IDR Trends

- Broad Questions: Examples

Please provide the following information for each of the employee sample units which have non-zero wage QREs:

- a. Supporting documentation that was relied on by the employee to substantiate the qualifying percentages reported for each sample unit.
- b. Technical supporting documentation for the research activities performed by these employees, including information on the business components.
- c. Patent applications or patents issued for work done for the employee sample unit.
- d. Year-end performance appraisals or annual reviews or similar documents or portions of those documents that cover the period of the reported QRE wages for these employees, that include, where applicable, the employee's achievements and manager's feedback related to the research activities being performed.

IRS Audits – IDR Trends

- Breakdown into Business Components: Examples

Please provide for each business component: Detailed supporting workpaper(s) and computation(s) that include the resulting qualifying percentage for the “Substantially-All” test. The computation should show if the business component met the 80% criteria of the substantially all requirements per Treas. Reg. §1.41-4(a)(6). Provide copies of supporting documentation as applicable.

Did you rely on “shrink back?” If so, explain in detail your methodology for applying the shrink back rule, including how you identified the sub-component to which to shrink back.

IRS Audits – IDR Trends

- Business Component Breakdown Requirement:
 - *Union Carbide Corp. v. Comm’r*, T.C. Memo. 2009-50:
 - Language of the statute and regulations ensures separation between expenses incurred as result of nonexperimental production-related activities from expenses incurred as a result of qualified process improvement activities.
 - Definition of “separate” business component under IRC § 41(d)(2)(C) and Treas. Reg. § 1.41-4(b)(1), (c)(2)(iii) is arguable.

How to Respond to IDRs

- Collect and review documents for responsiveness to direct requests, but also any additional documents evidencing research and development work performed and claimed during the audit period
- Provide documents in an organized manner, including cover pages with summaries and Bates stamping
- Be proactive with IRS communication and meeting deadlines
- To the extent broad information is requested by the IRS, provide an explanation regarding what records are and are not available or applicable

How to Best Position for IRS Audit

- Collect and organize substantiating materials contemporaneously when calculating and filing R&D credit claims
- Have a plan in place to retain these records in an organized manner for possible production to the IRS later
- Be proactive about filing refund claims well before the statute of limitations expires
- File credit claims with as much information and evidence as possible

How to Best Position for IRS Audit

- Substantive and complete data collection is essential to ensure best positioning for an audit.
- To reduce time and costs spent on data collection efforts, integrate technology contemporaneously with the R&D activities performed throughout the year and/or during the tax study process.
- Examples:
 - Using software to track time spent by employees on various activities in detail.
 - Using algorithms to gather and sort correspondence, data, and relevant information during the study process.

How to Best Position for IRS Audit

- Understand your facts and how your specific case is impacted by these issues
 - General methodology – How did you accumulate qualified research expenses – cost center, project-based, surveys, or sampling approach?
 - Availability of data – What data can be produced to address these concerns?
 - Other factors – What items may inhibit your ability to meet these new standards – employee turnover, dispositions of business units, volume of data, restrictions on what data may be shared?

How to Address IRS Concerns During an Exam

- What Has Not Been Effective in Addressing These Concerns
 - Responding “we didn’t do our study in the manner for which the IRS is requesting data”
 - Pushing back on the validity of requests
 - Simply dumping project and/or technical documents of your Exam Team in response to IDRs

How to Address IRS Concerns During an Exam

- How to Address the IRS Focus on Business Components
 - IRS Focus – Requiring taxpayers to demonstrate that QREs were properly captured using a business component approach
 - How It May Impact Taxpayers – Many taxpayers do not have the records readily available to substantiate their approach or used an alternative means to compute QRE
 - Best Practice – Carefully consider how to respond to these requests and consider what information can be provided to corroborate your position; tailor your surveys or samples to gather this information
- Depending on how you accumulated QRE, there may be a variety of potential responses that should be considered – take time to consider which approach best aligns with your facts.

How to Address IRS Concerns During an Exam

- How to Address the Substantially-All and Shrink-back Provisions of Section 41
 - IRS Focus – Once business components are identified, requiring taxpayers to demonstrate how 80% or more of costs constitute direct research and/or if shrink-back was applied in cases where the 80% rule is not met
 - How It May Impact Taxpayers – It may be difficult to determine what QREs within a business component are attributable to direct research, in particular, wage QREs of support and supervisory personnel
 - Best Practice – Consider where the IRS may have concerns such as:
 - Did you identify the “correct” business component
 - When was technical uncertainty resolved
 - What employees performed research vs. supported & supervised research
 - How were Supply and Contract Research QREs linked to research

How to Address IRS Concerns During an Exam

- How to Address the IRS Focus on Contemporaneous Documentation
 - IRS Focus – Require taxpayers to provide relevant technical documentation that demonstrates the type of research that was performed
 - How It Impact Taxpayers – Many taxpayers do not have “perfect” documentation that aligns with the Section 41 requirements
 - Best Practice – Ensure the documentation provided supports your case in the best possible manner, including:
 - Providing an overview of the documents and how they align to the project
 - If needed, drafting a brief project timeline that gives context to the documents
 - Reviewing documents to ensure they address what the IRS requested

Preparing for Appeals

- When the IRS has not developed the record, try to fill the record as much as possible:
 - Provide substantiating documents, even if not specifically requested in an IDR
 - Provide comprehensive statements and declarations from subject matter experts
 - Prepare clear presentations regarding the claims made and in response to any obvious open issues or anticipated questions before they are asked

Preparing for Appeals

- If this material is not in the record before Appeals, one may not be able to use it at Appeals
 - At best, the Appeals team will likely kick the case back to Exam for it to review the new material
 - At worst, the Appeals team may simply refuse to consider the material

Hot Topics – *Perficient* case and “Funded Research”

- *Perficient, Inc. v. Commissioner*, No. 7600-18 (Tax Court filed Apr. 19, 2018)
- Perficient Inc., a technology services company, challenged the IRS’s disallowance of its claim for over \$800,000 in research credits for tax year 2013 in Tax Court. Perficient argued that the IRS erred in finding that its research activities constituted funded research under section 41(d)(4)(H).
- Under the statute, taxpayers cannot claim credit for R&D expenses to the extent the research was funded by another person. Treas. Reg. § 1.41-4A(d) contains a two-part test providing when research activities are not funded by another person:
 - (1) The taxpayer must have taken on financial risk of failure;
 - (2) The taxpayer must retain substantial rights in the research results.

Hot Topics – *Perficient* case and “Funded Research”

- The case is currently pending in the Tax Court on cross-motions for summary judgment by both Perficient and the government. On July 11, 2022 Perficient filed a response to the government’s motion for partial summary judgment. The IRS, in turn, filed a reply on September 12th.
- Perficient argues that the “substantial rights” test is invalid from a procedural standpoint as it fails to incorporate a statement of basis and purpose in the 1983 proposed regulations as required by the APA and *Chevron*.
- Perficient also argues that the “substantial rights” test is invalid due to the fact that it is contrary to the definition of “funded research” according to section 41 and/or congressional intent.

Hot Topics – *Perficient* case and “Funded Research”

Other cases have interpreted the scope of the “substantial rights” standard:

- **Pivotal Case:** *Lockheed Martin v United States*, 210 F.3d 1366 (2000) – The Federal Court of Appeals found in favor of Lockheed Martin, finding that taxpayers can retain substantial rights to research as long as exclusive rights are not vested in another person. This set the standard for determining rights to research performed under contract.
- More recently, in *Populous Holdings Inc. v. Commissioner*, T.C. Docket # 405-17, the Tax Court referenced the *Lockheed* case in issuing an order finding that the right to use research without being required to compensate for it is a “substantial right.”
- Last year, in *Tangel v. Commissioner*, T.C. Memo 2021-1, the Tax Court found that a taxpayer did not retain substantial rights where the research contract did not allow the taxpayer to use the results from the research outside of the contract project without the consent of the client and with no limitations on the client’s withholding of such consent.

Hot Topics – *Perficient* case and “Funded Research”

- A ruling on the validity of the “substantial rights standard” could have broad implications.
 - Taxpayers may need to reevaluate contract terms, including which party has the right to claim research costs.
 - This may cause substantial burden on businesses that commonly perform services under contract in order to substantiate research credit claims in relation to funded research.

The Impact on Preparing Research Credits

- Monitor the results of on-going tax controversy to understand potential challenges to your research credits
- Evaluate changes to your computational process to adhere to the business component and substantially-all requirements, as well as the Section 174 capitalization requirement
- Educate business partners within your organization to understand what information / systems may be available
- If needed, gather additional / accurate information regarding the roles of employees that perform research
- Continue to gather supporting qualitative documentation that demonstrates the nature of the research being performed

Questions & Discussion



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Thank You

