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RESEARCH CREDIT REFUND CLAIMS— NEW IRS REQUIRE- MENTS

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In an IRS Chief Counsel Memorandum, No. 20214101F, released on 10/15/2021, the IRS notified taxpayers of additional detailed information that will be required when claiming valid research credit refunds. Treasury Regulations require that for a refund claim to be valid, it must set forth sufficient facts to apprise the IRS of the basis of the claim. The Chief Counsel Memorandum is intended to improve tax administration efficiency by providing taxpayers with clear instructions to claim the credit and by reducing the number of disputed claims.

Each year, the IRS receives thousands of research credit refund claims for amounts in the hundreds of millions of dollars from corporations, businesses, and individual taxpayers. Claims for the research credit are currently examined in a substantial number of cases and consume significant resources for both the IRS and taxpayers.

The new requirements

The new requirements are aimed at expediting IRS decisions on which claims can be immedi-

ately paid, and which will require further examination. Under the new guidelines, for a research credit refund claim to be considered valid, the taxpayer must:

- Identify all the business components to which the research credit claim relates for that year.
- For each business component: (1) identify all research activities performed; (2) identify all individuals who performed each research activity; and (3) identify all the information each individual sought to discover.
- Provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year.

Code Section 41 allows taxpayers a credit against income taxes that is a portion of the increased expenses incurred and attributable to qualified research activities (QRAs). To be considered a QRA, Section 41 requires the analysis to be broken down by each of the taxpayer's identified business components. Each business component must individually meet a statutory four-part test. Therefore, identification of each business component to which the

A new IRS Chief Counsel Memorandum sets forth additional detailed information that will be required when claiming valid research credit refunds.

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Section 41 research credit relates is a basic requirement and is why this information must be included in a refund claim for the claim to meet the IRS specificity requirement.

While it might be expected that the taxpayer identifies primary business components related to its current year claim, requesting information on all business components appears overly burdensome to most practitioners, along with the additional information being requested. For taxpayers with extensive research operations, spanning multiple locations and/or departments, complying with the new information requirements may prove very difficult, because they may account for project costs by department or cost center rather than by specific business components. The taxpayer's cost to identify, quantify, and detail every business component with specific information will reduce, and in some cases may even eliminate, the value of the research credit.

From the newly issued memorandum, once a business component is identified, the taxpayer must also demonstrate that it engaged in research. To determine whether there is qualified research as defined under Section 41, identifying who performed the research and the information that each individual who performed the research sought to discover is essential.

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The memorandum argues that without this specificity in the claim for refund, it is impossible to make a determination whether the taxpayer engaged in QRAs for the refund claim year. Thus, this information also must be included in a refund claim for the claim to meet the new IRS specificity requirement. The requirement is also ambiguous, because not all employees who perform QRAs will be conducting research—direct support or supervision of qualified research is also eligible for the research credit under Section 41.

The IRS justification for the new requirement is that having this specific information allows the IRS to determine if a refund should be paid immediately based on the information provided or if an examination should be conducted to verify the taxpayer's entitlement to the refund. The IRS will provide a grace period up until 1/10/2022 before requiring the inclu-

sion of this information with timely filed Section 41 R&D tax credit claims for refund.

Expenses attributed to qualified research activities that may be deemed qualified research expenses (QREs) generally include:

- Total wages paid or incurred to an employee for engaging in (directly, supervising, or supporting) qualified research activities;
- The cost of supplies used in qualified research activities; and
- 65% of any amounts paid to any non-employee to perform qualified research.

Importantly, the taxpayer must also provide a declaration signed under the penalty of perjury, verifying that the facts provided are accurate. In most cases, the taxpayer's signature on Forms 1040X or 1120X will suffice.

Additionally, the taxpayer should provide the facts in a written statement, rather than through the production of documents. However, if a taxpayer provides documents, including for example a completed R&D tax credit study, the taxpayer must specify the exact page(s) that supports each specific fact. Merely providing documents will not suffice to meet the taxpayer's obligation.

Here again practitioners are claiming foul by the IRS, for placing additional burdens on the taxpayer in the form of signature and documentation. There is also ambiguity in the written statement requirement because it is not clearly defined.

Finally, the refund claim must be filed within the period of limitations stated in Section 6511. Typically, taxpayers must file a valid claim within three years of the date their return was filed or two years from the time the tax was paid, whichever period expires later.

Interim guidance

On 1/3/2022, the IRS issued interim guidance and frequently asked questions to assist taxpayers in complying with its controversial memo.

Enforcement for these requirements began on 1/10/2022, start of a one-year transition period through 1/9/2023, where taxpayers will have 45 days to perfect their claim if any information is deemed missing or insufficient by the IRS. This is an increase from 30 days in the initial October 2021 memorandum. Any timely filed claims that are determined to be insufficient during the transition period will still be considered timely if perfected during this 45-day period.

Taxpayers will be notified that additional information is required with Letter 6428, Claim for Credit for Increasing Research Activities—Additional Information Required. The 45-day period to perfect the claim will start from the date the letter is issued. In the case that sufficient information is not received to perfect the claim, taxpayers will be issued Letter 6430, No Consideration, Section 41 Claim. The IRS indicates that all returns will be checked for the new refund claim required information, and that it may therefore take up to six months from receipt for the IRS to process these claims.

The IRS also provided additional guidance on its submission requirements, clarifying that taxpayers may group together employees who sought to discover the same information for a business component and describe what they collectively sought to discover. These employees may be identified by job title or position, rather than individual employee names. However, the taxpayer may be asked to provide the specific employee names after IRS review of the claim. Finally, taxpayers who used statistical sampling to determine their research credit refund claim, in accordance with Revenue Procedure 2011-42, will only need to provide information related to the projects contained in the sample.

Recent court cases

Some practitioners and legal experts have brought forth the somewhat controversial theory that the IRS Chief Counsel Memorandum was issued in response to a string of taxpayer victories in recent court cases involving refund claims and documentation requirements. If so, this may be perceived as a way to enforce their requirements without having court case precedent, and actually despite recent court decisions.

In *Harper*,¹ the owner of a military construction company filed amended returns for 2008 and 2010 to claim R&D tax credits in those years. The existing specificity requirement stated that a claim for refund “must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis.” The IRS denied the taxpayer’s claims and the district court upheld that Harper failed to establish grounds for the claims or to present facts to justify its R&D tax credits, essentially presenting only two Form 1040X attachments.

On appeal, however, the Ninth Circuit Court of Appeals reversed the prior decisions and determined that the government had waived its specificity requirement by conducting a four-year audit examination. According to the Court of Appeals, although the IRS is entitled to require taxpayers to provide information in a certain form, it may also seek the required information by investigation. The court determined that the IRS had waived its specificity requirement by accepting Harper’s tax forms and substantively examining his specific claims without asking for additional information.

More recently, in two separate 2021 decisions, taxpayers received favorable court rulings. In both the *Premier Tech*² and *Intermountain Electronics*³ cases, the IRS tried to disallow research credit refund claims on procedural grounds, rather than by litigating whether the asserted research activities meet Section 41 requirements. The government made motions to dismiss based on its assertion that the taxpayers’ administrative claims lacked specificity. In other words, the IRS could not determine why the taxpayers were entitled to their refund claims. The taxpayers argued that attachment of Form 6765 was sufficient to disclose the nature of their claims.

In the *Premier Tech* case, the court ruled in favor of the taxpayer, stating that the IRS could not now change its own rules and say that the amended return and research claim form were inadequate. In the *Intermountain Electronics* case, similar to the *Harper* case, the court ruled that the IRS’s extensive five-year audit proved the validity of the taxpayer’s claim and constituted a waiver of the specificity requirement. The government had a partial victory, subsequently arguing that Intermountain “failed to state a claim,” but the court provided Intermountain with an opportunity to replead with sufficient facts and evidence.

Conclusion—adding burdens to taxpayers

The research credit has always been a complex and somewhat subjective area of law, involving the application of a four-part test, numerous potential exclusions, and a variety of cal-

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¹ *Harper*, 127 AFTR2d 2021-1027 (CA-9, 2021).

² *Premier Tech, Inc.*, 128 AFTR2d 2021-5220 (DC UT, 2021).

³ *Intermountain Electronics, Inc.*, 128 AFTR2d 2021-5240 (DC UT, 2021).

calculation methods, all of which need to be accurately evaluated and applied to determine each taxpayer's sustainable claim in any given tax year. By forcing taxpayers to provide more information to evaluate their research credit claims, the newly released specificity requirements appear only to increase the burdensome nature of making the claims themselves, which discounts the value of research credits to taxpayers. The new IRS requirements disproportionately burden small and medium businesses that more commonly file an amended

return, compared to much larger, well-established companies.

It is important to keep in mind that being issued in the form of a memorandum rather than being published, these new requirements are considered "private guidance," and therefore are technically not binding on the IRS. It remains to be seen whether or not the IRS will further change the language and publish these new requirements in the form of a Revenue Ruling or Revenue Procedure in the Internal Revenue Bulletin. ■