

Code Sec. 41 Research and Experimentation Tax Credit Audit Considerations

*By Kreig D. Mitchell**

Kreig D. Mitchell examines the IRS's current approach for auditing Code Sec. 41 research and experimentation tax credits.

The Internal Revenue Code Section ("Code Sec.") 41 research and experimentation tax credit was enacted in 1981¹ to provide a significant tax incentive to encourage taxpayers to increase domestic research and experimentation spending.² However, recent IRS audit initiatives and procedures frustrate this goal, forcing many taxpayers to make a difficult business decision: claim the Code Sec. 41 tax credit as provided by Congress and face the almost certain prospect of a costly and time-consuming IRS audit, or forego the Code Sec. 41 tax credit altogether.

This article discusses the recent IRS initiatives and current audit procedures related to Code Sec. 41 tax credits. The article also explores the initial audit considerations and potential audit hazards that taxpayers encounter during Code Sec. 41 audits. Finally, an overview of the IRS's research credit recordkeeping agreement program is provided.

IRS Initiatives

Code Sec. 41 tax credits have been designated a Tier 1 issue.³ Pursuant to the IRS Large and Mid-Size Business (LMSB) operating division's Industry Issue Focus initiative, the IRS identifies and ranks high-risk tax issues using a tier ranking system.⁴ High-risk tax issues are those that are most prevalent across industries and that present the most compliance risk.⁵ Tier

1 issues have the "highest strategic importance" for the IRS.⁶ An IRS issue owner executive is assigned to each Tier 1 issue.⁷ Each Tier 1 issue owner is tasked with coordinating IRS resources and issuing guidance to ensure that Tier 1 issues are "resolved in a consistent manner across all LMSB cases involving similarly situated taxpayers."⁸

Code Sec. 41 tax credits also have been designated as a Compliance Coordinated Issue (CCI).⁹ CCIs include specific issues that arise in one or more industries.¹⁰ CCIs are identified by the IRS exam function to establish uniform positions within industry or issue areas.¹¹ Examination function technical advisors draft coordinated issue papers for CCIs.¹² The IRS has published four coordinated issue papers that address specific Code Sec. 41 tax credit issues.¹³

Code Sec. 41(d) has been designated as an Appeals Coordinated Issue (ACI).¹⁴ ACIs include broad issues or categories of cases identified by the appeals function that have "service-wide impact or importance" and that require "coordination to ensure uniformity and consistency nationwide."¹⁵ An appeals technical guidance coordinator is selected for each ACI.¹⁶ The appeals coordinator consults with appeals officers on individual cases and prepares and updates appeals settlement guidelines, which are not released to the public.¹⁷

IRS audit personnel are required to "review and follow" the issue owner executive's guidance.¹⁸ Audit personnel generally "cannot deviate from" positions developed in coordinated issue papers.¹⁹ They are allowed to settle coordinated issues at the IRS administrative examination level, as long as the settlements comport with the appeals settlement

Kreig D. Mitchell, J.D., LL.M., owns and operates the law office of Kreig Mitchell LLC in Denver, Colorado. To find out more about Kreig Mitchell, visit www.irstaxtrouble.com.

guidelines.²⁰ Both the appeals technical guidance coordinators and the audit technical advisors must review and consent to examination-level settlements.²¹ Conversely, appeals officers are not required to follow CCI guidance.²² Appeals officers must consult with and “get review and concurrence from” the appeals technical guidance coordinator prior to finalizing Code Sec. 41 tax credit settlement agreements with taxpayers.²³

Current Audit Procedures

The IRS audit team for Code Sec. 41 tax credits includes a revenue agent; one or more engineer agents and their manager; technical advisors; and possibly a computer audit technician and an attorney.²⁴ The revenue agent’s role is limited to serving as a liaison between the taxpayer and the IRS audit team.²⁵ The engineer agents and managers—most of whom have no tax, accounting or legal experience—gather and analyze the taxpayer’s Code Sec. 41 tax credit documentation.²⁶ The technical advisors serve as the IRS’s resident experts for Code Sec. 41 tax credit audit issues.²⁷ Computer technicians assist the engineer agents in developing statistical sampling techniques and reviewing computer-based records.²⁸ An IRS attorney may provide legal assistance to the technical advisors and engineer agents.²⁹

The Code Sec. 41 portion of an audit consists primarily of providing documents in response to IRS information document requests (IDR). The engineer agents issue an initial IDR for Code Sec. 41 tax credit audits; this IDR consists of a standardized response questionnaire containing 17 “yes-or-no” questions.³⁰ The engineer agents issue subsequent IDRs based on the taxpayer’s responses to the initial IDR.³¹ The engineer agents also may conduct initial meetings with the taxpayer, tour the taxpayer’s facilities and spend a day or two conducting employee interviews.³² Other than these brief in-person contacts, the taxpayer generally is not invited to present information outside the IDR response process.

The Code Sec. 41 tax credit audit generally ends when the revenue agent sends the taxpayer a formal 30-day letter. In most cases, the 30-day letter is sent to the taxpayer with a notice of proposed adjustment report prepared by the engineer agents. The report typically proposes a full disallowance or significant downward adjustment to the Code Sec. 41 tax credits claimed by the taxpayer.³³ The taxpayer then can agree with the notice of proposed adjustment, request an appeals conference or proceed with litigation.³⁴

Initial Audit Considerations

There are several audit considerations that taxpayers must address in every Code Sec. 41 tax credit audit. These considerations include (1) presenting sufficient records to substantiate the taxpayer’s Code Sec. 41 tax credits; (2) determining whether appropriate records are available; and (3) addressing estimates the taxpayer used to determine the Code Sec. 41 tax credits.

Substantiating Code Sec. 41 Tax Credits

Identifying and presenting sufficient records to substantiate Code Sec. 41 tax credits continues to be the most contentious issue between taxpayers and the IRS with respect to Code Sec. 41 tax credit audits. The two items that the taxpayer must substantiate for purposes of Code Sec. 41 are the taxpayer’s gross receipts and the expenses for qualified activities. Most of the controversy between the taxpayer and the IRS usually involves substantiating expenses for qualified activities.³⁵

The government has provided little guidance to taxpayers for documenting expenses for qualified activities.³⁶ The former Code Sec. 41 regulations required the taxpayer to prepare and retain written documentation before or during the early stages of the research project that described the principal questions to be answered and the information the taxpayer sought to obtain that exceeded, expanded or refined the common knowledge of skilled professionals in the relevant field of science or engineering to document expenses for qualified activities.³⁷ Congress deemed this requirement too burdensome for taxpayers and, as a result, the Treasury amended the regulations to abandon this requirement.³⁸ The current regulations state merely that a “taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.”³⁹ There are two sources of records the taxpayer can use to substantiate its qualified activities: its accounting records and its other business administrative or operations records.

Accounting Records

Accounting records generally are kept using a cost-center or project-based system of accounting.⁴⁰ Cost-center accounting refers to tracking expenses by department or other expenditure category.⁴¹ Cost-center records are based on a logical grouping of

activities that follows the organizational structure of the company and tracks costs based on where within the company structure the cost was incurred.⁴² Examples include engineering, sales and manufacturing departments, or supply, contract cost and payroll expense categories.

With cost-center accounting records, there is not necessarily a direct relationship between particular costs and activities within the cost-center accounting system.⁴³ As such, taxpayers who maintain cost-center accounting records must demonstrate that the activities undertaken within

each of the cost-centers consist of qualified research activities.⁴⁴ Providing records in this format can be very difficult for the taxpayer when the expenses for qualified activities are recorded in multiple cost-centers. Most taxpayers maintain accounting records using a cost-center system of accounting.

Accounting records also may be kept using a project-based system of accounting.⁴⁵ Project-based accounting refers to tracking expenses by individual project.⁴⁶ Project-based records directly match costs with the activities that gave rise to them.⁴⁷ Because project-based accounting records gather all costs associated with an activity in the accounting system, activities that are qualified for purposes of the Code Sec. 41 tax credit can be readily determined and matched to the costs associated with them.⁴⁸ Very few taxpayers maintain accounting records using a project-based system of accounting.

Business Records

Although accounting records can help identify qualified expenses, they generally do not capture information pertaining to the nature of research and experimentation activities undertaken by the taxpayer.⁴⁹ There are a number of business records that can help substantiate research and experimentation activities, including the following:

- Management reports and evaluations
- Bid packages, contracts and purchase orders
- Engineering drawings, design timelines and other engineering documents
- Organization charts, company telephone contact lists and written job descriptions

- Marketing materials
- Patent applications and related documentation
- Internal and external letters, e-mail and personal notes

Documents that show project or activity start and end dates are particularly helpful, because only expenses related to the research phase of a project count as qualified research expenses (QRE).⁵⁰ After the research activities are identified, the taxpayer can begin isolating expenses from the accounting records (whether project-based or cost-center-based) and assembling the documents

that substantiate the activities involved in the Code Sec. 41 tax credit claims.⁵¹

Availability of Base Period Records

The Code Sec. 41 tax credit is available only to taxpayers that increase their QRE spending in the year the credits are claimed over their QRE spending during the base period.⁵² Taxpayers must be able to show that their QRE spending increased between the base period and the years in which the credits are claimed.⁵³

The base period consists of years 1984 through 1988; however, the base period may consist of later tax years if the taxpayer is deemed to be a start-up company for purposes of Code Sec. 41.⁵⁴ A taxpayer is deemed to be a start-up company for purposes of Code Sec. 41 if the first tax year in which there were both gross receipts and QREs occurred after 1983 or, for the period beginning after December 31, 1983, and ending before January 1, 1989, there were fewer than three tax years in which the taxpayer had both gross receipts and QREs.⁵⁵ A start-up company taxpayer must use the base period rules set out in Code Sec. 41(c)(3)(ii) for calculating its Code Sec. 41 tax credits.⁵⁶

Code Sec. 41 provides that the QREs taken into account for purposes of the Code Sec. 41 tax credit during the base period are determined on a basis consistent with the determination of QREs for the credit year.⁵⁷ As applied, this consistency rule requires the taxpayer to use and retain the same records to determine and substantiate its base period gross receipts and QREs that it will use and retain for its credit year gross receipts and QREs. If project-based accounting

Identifying and presenting sufficient records to substantiate Code Sec. 41 tax credits continues to be the most contentious issue between taxpayers and the IRS with respect to Code Sec. 41 tax credit audits.

records or cost-center accounting records, supplemented by employee interviews or surveys, were used to determine credit year QREs, the taxpayer must use and retain similar records to determine and substantiate its base period QREs.

Some taxpayers that have not developed and retained extensive base period records may have claimed Code Sec. 41 tax credits using the Code Sec. 41 tax credit start-up company rules.⁵⁸ The IRS might argue that such taxpayers cannot use these rules and may never be entitled to claim Code Sec. 41 tax credits where base period records do not exist.⁵⁹

Taxpayer Reliance on Estimates

Some level of estimation is required for determining Code Sec. 41 tax credits, as few taxpayers have sufficient accounting and business records to fully substantiate base period and credit year research activities, QREs and gross receipts. Courts generally employ an estimation process where records that substantiate tax deductions and credits do not exist, if other evidence establishes that the taxpayer incurred some deductible or creditable expense.⁶⁰ IRS agents often adopt this judicial estimation technique at the IRS administrative audit level, based on the fact that, if challenged by taxpayers, the courts could employ the same technique.

Although some level of estimation may be permitted at the administrative audit level, the taxpayer should locate records that lend credence to any estimation used in determining the Code Sec. 41 tax credit. At a minimum, the taxpayer should locate records to substantiate any estimation used to determine base period gross receipts and credit year QREs and gross receipts. This may involve locating previously filed tax returns, old accounting records and any other supporting documents.

Potential Audit Hazards

There are several potential audit hazards that frequently arise during the course of Code Sec. 41 tax credit audits. These potential audit hazards include issues related to whether qualifying expenses are incurred and whether these expenses are QREs for purposes of Code Sec. 41.

Qualifying Expenses

Issues related to whether expenses are qualified often arise during the course of Code Sec. 41 tax credit audits. For purposes of Code Sec. 41, qualified expenses can include wages,⁶¹ supply costs⁶² and contractor

costs paid or incurred for qualified services in carrying on the taxpayer's trade or business.⁶³

The term "qualified services" includes engaging in qualified research or engaging in the direct supervision or direct support of research activities that constitute qualified research.⁶⁴ The term "direct supervision" means the immediate supervision of qualified research, and the term "direct support" means services in the direct support of either persons engaging in actual conduct of qualified research or persons directly supervising persons engaging in the actual conduct of qualified research.⁶⁵

Although job titles and job descriptions are not controlling, the taxpayer should expect the IRS to challenge wage QREs for employees whose job titles indicate that they would not engage in, support or supervise qualified research activities.⁶⁶ It is common for the IRS to focus the audit on wages paid to high-level and highly compensated employees whose job titles suggest they perform significant administrative duties, such as company presidents, chief executive officers and supervisors. It also is common for the IRS to focus on low-level employees whose job titles suggest that they perform significant manufacturing or quality assurance duties, such as machinists, tool makers and shop supervisors. Thus, taxpayers should collect documentation to substantiate the research and experimentation activities associated with these types of employees. This documentation might include to-do lists, personal notes and calendars, meeting minutes and even e-mail communications.

Taxpayers also should collect documentation to substantiate any supply or contractor costs claimed as QREs. Even where the taxpayer maintains cost-center records, the taxpayer often maintains one or more general ledger accounts to track research and experimentation expenses. These accounts often are indexed by purchase order number, which makes it possible to identify the dates and costs of such expenses. Employee testimony can be used to tie the expense to particular activities and to determine whether the activity was qualified.

Research Expenses

Issues related to whether the taxpayer incurred expenses for qualified research often arise during the course of Code Sec. 41 tax credit audits. The term "qualified research" means research:

- with respect to which expenditures may be treated as expenses under Code Sec. 174;
- undertaken for the purpose of discovering information that is technological in nature and the

application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and

- that constitutes elements of a process of experimentation for the purpose of achieving a new or improved function, performance, reliability or quality⁶⁷ to be eligible for expense treatment pursuant to Code Sec. 174, the expenses must be (1) related to developing a product's concept, plan or design; (2) paid or incurred in connection with a trade or business; and (3) reasonable under the circumstances.⁶⁸ Expenses for the acquisition or improvement of land or depreciable property are not eligible for expense treatment pursuant to Code Sec. 174.⁶⁹

Research is undertaken for the purpose of discovering information that is "technological in nature" if a process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering or computer science.⁷⁰ A "process of experimentation" is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities.⁷¹ Research is not conducted for a qualified purpose if it relates to style, taste, cosmetic or seasonal design factors.⁷²

The term "business component" refers to any product, process, computer software, technique, formula or invention that is to be held for sale, lease or license, or used by the taxpayer in a trade or business of the taxpayer.⁷³ A business component, such as a product, may consist of several subcomponents.⁷⁴ Where the product does not meet the conditions of qualified research, it may be necessary to consider the subcomponents as separate business components to determine if the subcomponents meet the conditions of qualified research.⁷⁵

Code Sec. 41(d)(4) specifies that the following activities are not considered to be research:

- Research conducted after the beginning of commercial production of the business component⁷⁶
- Research related to the adaptation of an existing business component to a particular customer's requirement or need

The current RCRA program imposes a number of restrictions on the agreements, which severely limits the usefulness of the program.

- Research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component
- Surveys or studies, including efficiency surveys; activities relating to management functions or techniques; market research, testing or development (including advertising or promotions); routine data collection; and routine or ordinary testing or inspection for quality control
- Research conducted outside the United States, the Commonwealth of Puerto Rico or any possession of the United States
- Research in the social sciences, arts or humanities
- Research to the extent funded by any grant, contract or otherwise by another person or governmental entity⁷⁷
- Research related to certain types of software and computer lease payments⁷⁸

Taxpayers should review their accounting and other business records in light of these rules. Where project-based accounting records are maintained and where the taxpayer's Code Sec. 41 tax credits are based on 50 or fewer projects, the taxpayer could select a few of its most research-intensive or well-documented projects and provide these documents as examples of qualified research activities conducted by the taxpayer. The taxpayer may be able to convince the engineer agents to limit the audit to just these projects.

Where project-based accounting records are maintained but the taxpayer's Code Sec. 41 tax credits are based on 50 or more projects, the taxpayer should consider developing statistically valid samples and providing the IRS with the records for the sample projects.⁷⁹ The taxpayer then can urge the IRS to apply the findings from those projects to similar projects that were not included in the samples. However, IRS computer audit technicians may dispute the statistical validity of samples selected by the taxpayer, and the IRS may select its own samples of projects.⁸⁰

Where cost-center accounting records were maintained, the taxpayer will need to develop a method

for establishing that the individual cost-centers were engaged in qualified research activities. In most cases, this involves providing many documents to the IRS for its consideration and review. Given the current IRS procedures, the taxpayer who cannot provide detailed project-based records should be prepared to present Code Sec. 41 tax credit claims to the IRS appeals office.

Research Credit Recordkeeping Agreements

The IRS offers certain taxpayers the opportunity to enter into research credit recordkeeping agreements (RCRA) so as to conserve the IRS's limited audit resources.⁸¹ RCRA are voluntary agreements entered into between taxpayers and the IRS that specify what records taxpayers are to keep to substantiate Code Sec. 41 tax credits.⁸² The RCRA terms related to what documents taxpayers are to create and retain are open for negotiation.⁸³ Taxpayers who comply with the terms of RCRA will be deemed to have satisfied the recordkeeping requirements for future Code Sec. 41 tax credits.⁸⁴

The current RCRA program imposes a number of restrictions on the agreements, which severely limits the usefulness of the program. RCRA do not specify what the taxpayer's fixed base percentage or base period should be.⁸⁵ RCRA do not obligate the IRS to treat expenses as QREs.⁸⁶ RCRA require the

taxpayer to agree to provide access to employees and records, should the IRS opt to examine the taxpayer's Code Sec. 41 tax credit claims.⁸⁷ RCRA may require the taxpayer to create and retain records that it currently does not create or retain.⁸⁸ Moreover, RCRA do not cover trades or businesses acquired by the taxpayer after the RCRA is entered into, and are limited to the three-year period following the issuance of the RCRA.⁸⁹ Given these restrictions and the recent IRS initiatives related to Code Sec. 41 tax credits, the current RCRA program may be best suited for taxpayers who have sizeable Code Sec. 41 tax credits.⁹⁰

Conclusion

The IRS expends a great deal of its limited audit resources examining Code Sec. 41 tax credit claims. Taxpayers should review their Code Sec. 41 tax credits in terms of how to present their claims, whether base-period records exist, and what estimations were employed in determining the credit amounts. Taxpayers also should consider whether the potential audit hazards identified in this article might impact their Code Sec. 41 tax credits and whether to apply for a RCRA. Proactive and stepped-up efforts by taxpayers can go a long way in securing the significant tax savings associated with these tax credits.

ENDNOTES

* This article is modified from an original publication in 37 COLORADO LAW. 3 (Mar. 2008).

¹ Code Sec. 41 research and experimentation tax credit initially was enacted as Code Sec. 44F pursuant to Act Sec. 221 of the Economic Recovery Tax Act of 1981 (P.L. 97-34). Code Sec. 44F was redesignated as Code Sec. 30 pursuant to Act Sec. 471(c) (1) of the Deficit Reduction Act of 1984 (P.L. 98-369). Act Sec. 231(d)(2) of the Tax Reform Act of 1986 (P.L. 99-514), amended the Code Sec. 41 tax credit provisions and redesignated Code Sec. 30 as Code Sec. 41. Despite its popularity with taxpayers, the Code Sec. 41 tax credit has never been made permanent.

² Staff of Joint Comm. on Taxation, 97th Cong., 1st Sess., *General Explanation of the Economic Recovery Tax Act of 1981* 120-21 (Jt. Comm. Print 1981). The U.S. Treasury Department estimates that the Code Sec. 41 tax credit will save taxpayers \$132 billion between 2008 and 2017. U.S. Department of Treasury, *Treasury Conference on Business Taxation and Global Competitiveness*,

available at www.treas.gov/press/releases/reports/07230%20r.pdf.

³ Industry Director Directive #1 on Research & Experimentation (R&E) Credit Claims, available at www.irs.gov/businesses/article/0,,id=169273,00.html.

⁴ IRS Industry Issue Focus Fact Sheet, available at www.irs.gov/businesses/article/0,,id=168490,00.html. The LMSB operating division serves corporations, subchapter S corporations and partnerships with assets greater than \$10 million.

⁵ *Id.*

⁶ *Id.*

⁷ INTERNAL REVENUE MANUAL (IRM) §4.51.1.3. The IRM is available online at www.irs.gov/irm.

⁸ *Id.*

⁹ A list of CCIs is available at www.irs.gov/individuals/article/0,,id=108655,00.html.

¹⁰ IRM §§4.40.1.1.1.7 and 8.4.3.2.1.

¹¹ *Id.*

¹² IRM §4.32.1.4.1.

¹³ List of CCIs, *supra* note 9.

¹⁴ A list of ACIs is available at www.irs.gov/individuals/article/0,,id=108652,00.html.

The IRS initially designated only Code Sec. 41(d)(1) as an ACI. The IRS recently issued a memorandum and draft report to expand the ACI designation to include paragraphs (2), (3) and (4) of subsection (d) and related penalties. *Draft Report Outlines Substantiation Requirements for Research Credit*, 2007 TNT 69-6 (Apr. 10, 2007). The other portions of Code Sec. 41, such as subsections (b), (f) and (g), have not been designated as ACIs. This recent memorandum and draft report address substantiation requirements associated with Code Sec. 41(d). The related penalties may include the Code Sec. 6694 tax preparer penalty and the Code Sec. 6707A reportable transaction penalty.

¹⁵ IRM §8.7.3.2.2.

¹⁶ IRM §8.7.3.2.

¹⁷ IRM §§8.7.3.3.1 and 8.7.3.2.1.

¹⁸ Industry Director Directive, *supra* note 3.

¹⁹ IRM §4.40.1.1.1.7.

²⁰ Delegation Order 4-25, available at www.irs.gov/pub/irs-utl/do_4_25.pdf. The settlements must first be reviewed and approved by the technical advisors and LMSB team managers who have jurisdiction over the

ENDNOTES

- case.
- ²¹ IRM §8.7.3.4.3.
- ²² IRM §§8.7.3.2.1(2) and 4.32.1.4.1.
- ²³ IRM §8.7.3.2.2.
- ²⁴ See *Credit for Increasing Research Activities (i.e., Research Tax Credit) Audit Techniques Guide, Large and Mid-Size Business Division Pre-Filing and Technical Guidance* (June 2005).
- ²⁵ LMSB revenue agents work for one of the five LMSB industry functions. Revenue agents may audit non-Code Sec. 41 issues during the course of the Code Sec. 41 tax credit audit, which may impact the taxpayer's Code Sec. 41 tax credits. For example, the revenue agents may opt to review issues related to the taxpayer's credit year gross receipts.
- ²⁶ IRS engineers work for the LMSB; field specialists function as part of the Engineer Specialist Program.
- ²⁷ Technical advisors work for the LMSB, Office of Prefiling and Technical Guidance, as part of the Technical Advisor Program. This is similar to the appeals division's Appeals Technical Guidance Program.
- ²⁸ Computer audit specialists work for the LMSB Field Specialist function as part of the Computer Audit Specialist Program.
- ²⁹ IRS attorneys work for the IRS Office of Chief Counsel.
- ³⁰ The IRS has been finalizing this IDR questionnaire. Some IRS revenue and engineer agents still may be using an older and shorter version of the questionnaire.
- ³¹ The questions typically will be pulled directly from a bank of questions prepared by the IRS specifically for Code Sec. 41 tax credit audits. The AUDIT TECHNIQUES GUIDE that is available on the IRS's internal computer network identifies this IDR question list. Taxpayers can obtain a copy of this version of the AUDIT TECHNIQUES GUIDE by submitting a Freedom of Information Act request to the IRS.
- ³² *Id.*
- ³³ These reports usually contain a standard statement of the law that is broad and does not address any of the specific legal issues that may be involved with the taxpayer's audit.
- ³⁴ Generally, taxpayers have to file a formal protest in response to the IRS's 30-day letter to have the IRS Appeals Office review the notice of proposed adjustment. The decision to proceed with litigation may depend on whether the Code Sec. 41 tax credits were claimed on original or amended tax returns. With regard to credits claimed on original tax returns, taxpayers either have to wait for the IRS to issue a 90-day letter to petition the tax court or pay the tax and sue for a refund in federal district court or the federal court of claims. Where credits are claimed on amended tax returns, taxpayers can bring suit in federal district court or the federal court of claims if the claims were not paid by the IRS within six months after the claim was submitted to the IRS.
- ³⁵ The preamble to the current regulations states that the "Treasury and the IRS recognize that the research credit presents a particular burden for taxpayers because tracking eligible expenditures may necessitate taxpayers preparing and keeping records unlikely to be prepared or kept for other business purposes." Preamble, 66 FR 66362.
- ³⁶ The preamble to the current regulations states that "the failure to keep records in a particular manner ... cannot serve as a basis for denying the [research and experimentation tax] credit." *Id.*
- ³⁷ T.D. 8930, 2001-1 CB 433.
- ³⁸ Preamble, *supra* note 35, citing H.R. CONF. REP. NO. 106-478, at 32 (1999).
- ³⁹ Reg. §1.41-4(d). The regulations also specify that the general Code Sec. 6001 recordkeeping requirements apply to Code Sec. 41 tax credits, which also provides scant guidance to taxpayers as to what records must be retained.
- ⁴⁰ See Research Credit Technical Advisor Program, *Briefing Paper on Taxpayer Approaches to Capturing Costs for the Research Credit*, available at www.irs.gov/pub/irs-utl/cost_capturing_approaches_2004-05-24.pdf.
- ⁴¹ *Id.*
- ⁴² *Id.*
- ⁴³ *Id.*
- ⁴⁴ *Id.*
- ⁴⁵ *Id.*
- ⁴⁶ *Id.*
- ⁴⁷ *Id.*
- ⁴⁸ *Id.*
- ⁴⁹ *Id.*
- ⁵⁰ See Code Sec. 41(d)(4)(A).
- ⁵¹ Taxpayers may consider creating supporting documents where records do not exist or cannot be located, such as distributing employee surveys, conducting employee interviews or obtaining employee testimony through affidavits. However, IRS employees often view these types of documents with suspicion if they were not created during the years needed to calculate the credit. This is especially true of documents created after the taxpayer is notified of the Code Sec. 41 tax credit audit.
- ⁵² *Id.*
- ⁵³ The formula for calculating the Code Sec. 41 tax credit uses the terms "base amount" and "fixed-base percentage" to determine whether taxpayers increased their qualified research expense (QRE) spending. The base amount is the average gross receipts for the four years prior to the credit year, multiplied by the fixed-base percentage. Code Sec. 41(c)(1). The fixed-base percentage is the percentage that research and experimentation spending was of gross receipts for the base period. Code Sec. 41(c)(3). The maximum fixed-base percentage is 16 percent. Code Sec. 41(c)(3)(C).
- ⁵⁴ Code Sec. 41(c)(3)(B). The base amount may not be less than 50 percent of the QREs for the credit year. Code Sec. 41(c)(2).
- ⁵⁵ Code Sec. 41(c)(3)(B)(i).
- ⁵⁶ *Id.*
- ⁵⁷ Code Sec. 41(c)(5).
- ⁵⁸ Some IRS employees have taken the position that taxpayers must use the start-up rules where base period records do not exist; however, the Code Sec. 41 base period rules do not provide for this.
- ⁵⁹ The IRS also might argue that taxpayers who do not maintain perfect base period records must claim the maximum 16-percent fixed-base percentage, which would, in effect, prevent most taxpayers from claiming Code Sec. 41 tax credits.
- ⁶⁰ *G.M. Cohan*, CA-2, 2 USTC ¶489, 39 F.2d 540 (1930). The IRS often cites Code Sec. 6001 and *N.E. Eustace*, CA-7, 2003-1 USTC ¶50,133, 312 F.3d 905, in support of this position that no estimations are permissible with respect to Code Sec. 41 tax credits. Even where the IRS takes the position that estimations are not permissible, the IRS often will use estimations in proposing downward adjustments to Code Sec. 41 tax credits claimed by taxpayers. Taxpayers often cite *E.V. Fudim*, Dec. 67 TCM 3011, 49,867(M), TC Memo. 1994-235, in support of the position that some level of estimation is appropriate.
- ⁶¹ The term "wages" means all remuneration for services performed by an employee for his or her employer, including employee benefits. See, e.g., *Apple Computer, Inc.*, 98 TC 232 (1992); *Sun Microsystems, Inc.*, 69 TCM 1884, Dec. 50,478(M), TC Memo. 1995-69. The term "wages" also incorporates all of the exclusions set out in Code Sec. 3401(a), including the exclusion for contributions to a deferred compensation plan arrangement under Code Sec. 401(k). Code Sec. 41(b)(2)(D); IRS Coordinated Paper, *Qualifying Wages Under Section 41 in Determining the Tax Credit for Increasing Research Activities* (Feb. 16, 1999), available at www.irs.gov/pub/irs-isp/all-wage.pdf.
- ⁶² The term "supplies" means any tangible property except for depreciable tangible property. Code Sec. 41(b)(2)(C). The term "supplies" does not include expenses for the use of personal property that are indirect research expenditures or general and administrative expenses, unless the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures. Reg. §1.41-2(b)(1) and (2)(i).

ENDNOTES

For example, amounts paid for electricity used for general laboratory lighting are treated as general and administrative expenses, but amounts paid for electricity used in operating high-energy equipment for qualified research (such as laser or nuclear research) may be treated as expenditures for supplies used in the conduct of qualified research to the extent the taxpayer can establish that the special character of the research required an extraordinary additional expenditure for electricity. IRS Coordinated Paper, *Credit for Increasing Research Activities—Extraordinary Expenditures for Utilities* (May 9, 2006), available at www.irs.gov/pub/irs-utl/credit_for_increasing_research_activities_final.pdf.

⁶³ Code Sec. 41 classifies wages and supply costs as “in-house research expenses” and contract expenses as “contract research expenses.” Only contract research expenses are subject to the “trade or business” requirement. Code Sec. 41(c)(4). Contract research expenses are limited to 65 percent of the amounts actually expended. Code Sec. 41(b)(3).

⁶⁴ Reg. §1.41-2(c).

⁶⁵ *Id.* For example, direct support includes wage, supply or contractor costs paid for a secretary typing reports describing laboratory results derived from qualified research, a laboratory worker cleaning equipment used in qualified research, a clerk compiling research data and a machinist machining a part of an experimental model used in qualified research. Direct support does not include wages, supply or contractor costs paid for personnel preparing salary checks of laboratory scientists, accountants for accounting for research expenses, janitors for general cleaning of a research laboratory or officers for supervising financial or personnel matters. IRS Coordinated Paper, *Credit for Increasing Research Activities—Qualified Research Expenses* (June 18, 2004), available at www.irs.gov/pub/irs-utl/qualified_research_expense_cip_final.pdf.

⁶⁶ The IRS AUDIT TECHNIQUES GUIDE specifies that job titles alone are not determinative, and directs IRS agents to focus on the actual activities performed by the employees. AUDIT TECHNIQUES GUIDE, *supra* note 24.

⁶⁷ Code Sec. 41(d)(1).

⁶⁸ Reg. §1.174-2(a); Code Sec. 174(a)(1) and (e). Congress added the reasonableness

requirement to Code Sec. 174 to prevent unreasonable salaries from qualifying as research expenses. H.R. REP. NO. 247, 101st Cong., 1st Sess. 1203, note 12 (1989), *overruling G.K. Driggs*, DC-TX, 89-1 USTC ¶9188, 706 F.Supp.20. Supply or contractor costs may not be subject to this reasonableness requirement.

⁶⁹ Code Sec. 174(c). Although expenses to acquire depreciable property to be used in qualified research are not deductible pursuant to Code Sec. 174, wage QREs associated with projects that culminate in a product that is a depreciable asset may be qualified for purposes of Code Sec. 174. Reg. §1.174-2(b)(4). Supply cost QREs associated with projects that culminate in products that are depreciable assets will not be qualified for purposes of Code Sec. 174. *Id.* However, contractor QREs paid to the contractors to purchase depreciable property to be used in qualified research may be qualified for purposes of Code Sec. 174, as long as the contractors retain the property. Reg. §1.174-2(a)(9).

⁷⁰ Reg. §1.41-4(a)(4). The IRS used to take the position that taxpayer research and experimentation had to exceed what was known in the field in which taxpayers were performing research. *See, e.g., Norwest*, 110 TC 454 (1998). After several legislative pronouncements and court opinions, the IRS now concedes that this discovery test is satisfied when the research and experimentation rely on principles of hard sciences. AUDIT TECHNIQUES GUIDE, *supra* note 24. Many IRS engineer agents still handle Code Sec. 41 tax credit audits as if the old discovery test still applies.

⁷¹ Reg. §1.41-4(a)(5).

⁷² Code Sec. 41(d)(3)(B).

⁷³ Code Sec. 41(d)(2)(B).

⁷⁴ *See* Reg. §1.41-4(b)(2).

⁷⁵ *Id.*

⁷⁶ Research is conducted after the beginning of commercial production if the activities are conducted after the component is developed to the point where it is ready for commercial sale or use or its meets the basic functional and economic requirements of the taxpayer for the component's sale or use. CCA 20071702F. The following activities are deemed to occur after the beginning of commercial production of a business component: preproduction planning

for a finished business component; tooling-up for production; trial production runs; trouble shooting involving detecting faults in production equipment or processes; accumulating data relating to production processes; and debugging flaws in a business component. *Id.*; Reg. §1.41-4(c)(2)(ii).

⁷⁷ Code Sec. 41(d)(4)(H); Reg. §1.41-2(e)(2). Research is considered to be funded research if the parties contractually agree that the taxpayer will be paid even if the research is not successful (*i.e.*, the taxpayer does not bear any economic risk) or if the parties contractually agree that the taxpayer is precluded from exploiting the research results (*i.e.*, the taxpayer does not retain substantial rights). *Fairchild Inds., Inc.*, CA-FC, 95-2 USTC ¶50,633, 71 F.3d 868; *Lockheed Martin Corp.*, CA-FC, 2000-1 USTC ¶50,401, 210 F.3d 1366.

⁷⁸ *See, e.g.,* Code Sec. 41(d)(4)(E); *Norwest*, *supra* note 70.

⁷⁹ *Field Directive on the Use of Statistical and Judgment Sampling in Research Field Cases*, available at www.irs.gov/pub/irs-utl/field_directive_samp_method_research_credit_cases.pdf.

⁸⁰ Research Credit Technical Advisor Program, *supra* note 40.

⁸¹ On February 9, 2004, the IRS instituted a pilot program to allow taxpayers who claimed Code Sec. 41 tax credits on timely filed original Form 1120, *U.S. Corporate Tax Returns*, and whose returns were currently under audit to enter into RCRA's. Notice 2004-11, 2004-1 CB 434. The IRS has continued the RCRA program beyond the term of the initial pilot program. On January 19, 2007, the IRS requested comments regarding the RCRA program. Comment Request: Notice 2004-11, 2007 ARD P 020-2.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ Toyota Motor North America, Inc. and subsidiaries and American Honda Motor Co., Inc. and subsidiaries entered into RCRA's with the IRS. *Research Credit Recordkeeping Agreements* (June 8, 2005), available at www.irs.gov/businesses/article/0,,id=139605,00.html.

This article is reprinted with the publisher's permission from the JOURNAL OF TAX PRACTICE & PROCEDURE, a bi-monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the JOURNAL OF TAX PRACTICE & PROCEDURE or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH.