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Exam

New Documentation “Requirements” for R&E Refund Claims Raises Concerns

By George A. Hani and Samuel A. Lapin*

I. Introduction

In 1981, Congress observed a decline in investment in essential research and experimentation activities and became concerned that this decline was harming not only the American economy but also its prestige and competitiveness on the world stage.¹ In response, Congress enacted the research and experimentation tax credit (“R&E Credit”) to encourage private investment in research and experimentation activities.² Over the past 30 years, the R&E Credit has become an important benefit for many taxpayers.

Determining whether and in what amount a taxpayer is eligible for the R&E Credit can be a complex and fact-dependent process for both taxpayers and the IRS. As a result, some taxpayers hire advisors to assist with the determination and many taxpayers file refund claims for the R&E Credit on an amended return.

A valid refund claim must, among other things, state each ground upon which the taxpayer bases its claim for refund and sufficient factual basis for each ground (the “specificity requirement”).³ This is true for all refund claims, not just refund claims based on the R&E Credit. Generally, taxpayers do not have to meet a high bar to satisfy the specificity requirement. Similar to notice pleading under the Federal Rules of Civil Procedure, taxpayers need only provide facts specific enough to alert the IRS to the nature of the claim. If the IRS can identify the nature of the claim but needs additional information, it can request such information from the taxpayer before paying out the refund. On the other hand, if the IRS determines that a refund claim is deficient, it can reject the claim or simply not address it.⁴ A valid refund claim is a jurisdictional requirement to a refund suit.⁵ A taxpayer that proceeds with a refund suit based on a claim that the IRS determined is deficient can expect that it would have to first defeat a motion to dismiss by the government before the court will consider its claim on the merits.

Because of the fact-intensive nature of the R&E Credit, audits of R&E Credit claims can be long and costly for both the IRS and taxpayers. In an apparent effort to reduce the number of R&E Credit refund claims under audit and in litigation,

IRS issued a Chief Counsel Advice Memorandum (the “IRS Memo”) to examiners that reinterprets the specificity requirement with respect to refund claims for the R&E Credit such that the amount of information required for a valid R&E Credit refund claim is drastically increased. If a taxpayer does not provide all of the required information, the IRS Memo advises examiners to reject their refund claim as deficient before engaging on the substance of the claim in any way.

It should be noted that neither the Internal Revenue Code (“Code”) nor the Treasury Regulations impose a higher burden on R&E Credit claims as compared to other claims. The IRS Memo nevertheless imposes a huge administrative burden on the taxpayer to provide with any R&E Credit refund claim filed on an amended return much of the information it would provide during an audit.

II. Background

Under Code Sec. 41, taxpayers are allowed a credit equal to 20% of the increase in its qualified research expenses (“QREs”) spent on qualified research projects in the current tax year relative to previous tax years. QREs include the cost of wages and supplies for certain qualified research activities performed by a taxpayer’s employees and 65% of expenditures for research activities performed by nonemployees.

Qualified research projects are identified using the following four-part test:

1. The research must be research for which expenditures are deductible under Code Sec. 174.
2. The research must be undertaken to discover information that is technological in nature.
3. The research must be undertaken to discover information that is intended to be useful in the development of a new or improved business component.
4. Substantially all of the activities that comprise the research must constitute elements of a process of experimentation.

Each research project in connection with a business component for which the taxpayer claims the R&E Credit must satisfy the four-part test.

A business component in the context of the R&E Credit is a broad concept, which covers a wide range of tangible and intangible properties from which a taxpayer plans to derive income. Specifically, a business component is defined as any product, process, computer software, technique, formula, or invention that the taxpayer plans to use in its trade or business or that the taxpayer plans to hold for sale, lease, or license.⁶

As this definition makes clear, a “component” is not limited to a product but includes more amorphous items such as a “process” or a “technique”.

Taxpayers detail their claimed R&E Credits on Form 6765, which they submit with their income tax return. Form 6765 shows, on a high level, how the taxpayer calculated its base amount of QREs, how many QREs come from the various sources set forth in Code Sec. 41, and how the taxpayer ultimately computed its R&E Credit.

In the IRS Memo, the IRS takes the position that the information on Forms 1120X and 6765 does not allow the IRS to effectively assess the claimed R&E Credit and, therefore, does not by itself constitute a valid R&E Credit refund claim. Rather, the IRS Memo provides that a taxpayer must, at a minimum, provide the following information for an amended return, in addition to Form 6765, to constitute a valid R&E Credit refund claim:

1. All business components in connection with which the taxpayer is claiming the R&E Credit.
2. For each business component:
 - a. All research activities performed;
 - b. All individuals who performed each research activity; and
 - c. All the information each individual sought to discover.
3. Total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses.

The IRS Memo asserts that because the R&E Credit involves a highly factual determination, the above information is necessary to apprise the IRS of the basis of the refund claim and to screen claims to determine which are valid and which require further investigation.

The IRS Memo specifies that taxpayers should provide information regarding business components and individuals’ activities in a written statement rather than through the production of documents. If a taxpayer does attach documents to its amended return in support of its R&E Credit claim, the IRS Memo requires that the taxpayer identify where the required factual support can be found within the refund claim. The taxpayer must also sign the written statement under penalties of perjury. The total qualified wage, supply, and contract research expense can be provided on the Form 6765.

Where the IRS determines that a taxpayer’s R&E Credit claim does not meet the specificity requirement, the IRS Memo advises examiners to reject the refund claim before conducting any audit activity. By rejecting the claim, the

IRS hopes to avoid waiving the specificity requirement or having a court treat an otherwise deficient claim as valid under the informal claim doctrine.

The IRS Memo was issued following a series of cases in which courts denied the IRS's motions to dismiss and instead found that they had subject matter jurisdiction to hear taxpayers' refund suits. In two cases, *Harper*,⁷ and *Intermountain Electronics, Inc.*,⁸ the court found that the IRS had waived the specificity requirement. And in a third, *Premier Tech., Inc.*,⁹ the court addressed how much factual support is necessary to meet the specificity requirement.

In *Harper*, the 9th Circuit Court of Appeals reversed an order of the district court granting the government's motion to dismiss for lack of jurisdiction. The taxpayers filed amended tax returns for 2008 and 2010 on each of which they made an R&E Credit refund claim, detailed in a properly completed Form 6765. The IRS selected the taxpayers' amended returns for examination and determined that the taxpayers had not proven their eligibility for the R&E Credit. When the taxpayers filed a refund suit, the IRS moved to dismiss for lack of jurisdiction because the taxpayers' amended returns did not meet the specificity requirement. The district court granted the IRS motion, holding that taxpayers' Forms 6765 were insufficient to meet the specificity requirement. The district court found that while the Forms 6765 "identified the ground for these credits, they failed to set forth facts sufficient to appraise the Commissioner of the exact basis thereof."

On appeal, however, the court reversed and held that the district court did have jurisdiction over the taxpayers' refund suit. The court did not address whether the taxpayers' Forms 6765 were sufficient to meet the specificity requirement. Rather the court held that the IRS waived the specificity requirement. The court found that the four-year audit examined the taxpayer's methods of tracking QREs, the taxpayer's business components, and whether it met the four-part test in Code Sec. 41(d). The court also found the fact that the IRS advised the taxpayer of the right to judicial review to be a "strong indication" of a substantive determination on the merits. Based on those findings, the court held that "[t]he IRS's substantive examination and final denial on the merits constitutes a textbook case of waiver."

Similarly, in *Intermountain Electronics*, the District Court for the District of Utah found that the IRS waived the specificity requirement. There, the taxpayer engaged an advisor to perform an R&E Credit study for years prior to 2014. As a result of the study, the taxpayer filed amended

returns for 2010 and 2011, which included Forms 6765. The IRS conducted an audit of those years and determined that the taxpayer did not prove its eligibility for the credit. When the taxpayer filed a refund suit, the IRS argued that the amended return did not constitute a valid refund claim and moved to dismiss for lack of jurisdiction. The IRS argued that the Form 6765 is necessary but not sufficient for a valid R&E Credit refund claim. Specifically, the taxpayer's refund claim was deficient because it did not (1) specify, upon request from the IRS, what process of experimentation was performed on what business component; (2) specify which employees performed processes of experimentation and how much time they spent on such processes; (3) provide evidence sufficient to calculate the taxpayer's base amount.

Determining whether and in what amount a taxpayer is eligible for the R&E Credit can be a complex and fact-dependent process for both taxpayers and the IRS. As a result, some taxpayers hire advisors to assist with the determination and many taxpayers file refund claims for the R&E Credit on an amended return.

The court held that the IRS waived the specificity requirement by conducting its audit. The court dismissed the IRS's argument that the IRS did not waive the specificity requirement because it rejected the taxpayer's refund claims for a lack of supporting information without reaching the substance of the claim. Rather, the court cited *Harper* in finding that "while the IRS ultimately may not have been satisfied with the information provided by Intermountain, it is clear not only that it understood the factual basis for Intermountain's claim, [but also that] its disallowance was based on the merits of the claim." Therefore, the court held that the IRS waived the specificity requirement.

Because the court reversed based on the waiver doctrine, the court did not ultimately decide whether the Form

6765 is sufficient to satisfy the specificity requirement. Nevertheless, the court described the IRS position in *dicta* as follows:

Apparently, the Government is suggesting that in order to duly file a claim for this sort of refund, the taxpayer either needs to *sua sponte* submit along with Form 6765, through some unspecified means, all supporting factual evidence to support its refund claim, or it must endure the IRS's complete investigative process, through which it submits requested evidence, before the claim can be considered duly filed. The Government's approach would appear to place quite a heavy burden on taxpayers.

The IRS Memo acknowledges that *Harper* and *Intermountain Electronics* stand for the proposition that an imperfect R&E Credit refund claim will be treated as valid where the IRS engages in a substantive examination of the refund claim and disallows the credit based on what "appears to be" the merits. In an apparent reaction to these cases, the IRS Memo recommends that examiners reject deficient R&E Credit refund claims before conducting any examination of the credit on its merits and before the taxpayer has a chance to perfect the claim to prevent them from being treated as valid under the waiver or informal claim doctrines.

Finally, while the IRS Memo has roots, in part, in recent court decisions and applies only to claims for the R&E Credit, taxpayers should be on the lookout for the application of this strategy to refund claims for other fact-intensive tax benefits.

Premier Tech stands in stark contrast to *Harper* and *Intermountain Electronics*. In this case, the District Court for the District of Utah addressed the quantum of support necessary to satisfy the specificity requirement in an R&E Credit refund claim. The taxpayer filed an amended return for 2014 in which it claimed the R&E Credit. The amended return included a properly filed Form 6765.

The IRS never addressed the amended return and when, after six months, the taxpayer filed a refund suit, the IRS moved to dismiss for lack of jurisdiction. The IRS argued that because the taxpayer did not include documentation that described the research it conducted, explained how that research contributed to the development of a business component, detailed expenditures on wages and supplies, or proved the taxpayer's base amount, the refund claim was deficient. The court denied the IRS motion, holding that the taxpayer's refund claim was sufficiently specific. The court held that the IRS position that "its own forms are not sufficient to constitute claims for refunds" would "lead to absurd and patently unfair results for taxpayers." And the court echoed the *dicta* from *Intermountain Electronics* in holding that "under the government's position, no tax return claiming tax credits for increasing research activities could possibly constitute a claim for refund."

While *Premier Tech* rejects the premise behind the IRS Memo's articulation of what is needed to satisfy the specificity requirement for R&E Credit claims, the IRS Memo acknowledges *Premier Tech* in only a footnote stating that "[t]he Service and Counsel are currently evaluating the opinion."

III. Concerns for Taxpayers

The stated goal of the IRS Memo is to clarify the minimum requirements for a valid R&E Credit refund claim because case law in the area is "limited, fact-specific, and still developing." But this stated goal is belied by its issuance in response to taxpayer favorable case law in *Harper*, *Intermountain Electronics*, and *Premier Tech* and its focus on the waiver doctrine. Rather, the evident goal of the IRS Memo is to reduce the number of R&E Credit refund claims that the IRS audits and ultimately litigates.

The IRS is rightly concerned about taxpayers who make abusive R&E Credit refund claims. But the new requirements imposed in the IRS Memo are a blunt instrument that will serve a chilling effect on even the most legitimate claims. Rather than target the taxpayers engaging in abusive tactics, the IRS Memo treats all taxpayers that claim the R&E Credit on an amended return as abusers. The result is a cynical policy that aims to clear out a backlog of R&E credit claims and deter future claims (whether abusive or not) from being made.

First, the minimum requirements set forth in the IRS Memo impose a draconian administrative burden on taxpayers. The increased requirements make it much

more difficult and expensive for taxpayers large and small to meet the specificity requirement, as articulated in the IRS Memo. The administrative burden for large taxpayers, which may have thousands of business components and thousands more employees, is immense. And for small taxpayers, even those that have only a few business components and employees, the cost of preparing the amended return and the risk of litigation may be a complete barrier to claiming the credit for a particular year.

Second, the recommendation in IRS Memo that IRS examiners reject any R&E Credit refund claims that are deficient under the IRS Memo before investigating the substance of the claim and before the taxpayer has an opportunity to perfect the claim raises serious questions of fairness. This recommendation is ostensibly meant to prevent IRS examiners from waiving the specificity requirements, which may be reasonable advice after the *Harper* and *Intermountain Electronics* decisions. But the effect of this recommendation—particularly in light of the massive amount of information required in the IRS Memo to meet the specificity requirement—is to completely prevent any administrative review of the actual R&E Credit refund claims. Taxpayers will be forced into federal district court to seek any review of their claims and, because a valid refund claim is a jurisdictional prerequisite to filing a refund suit, they will also regularly have to survive a motion to dismiss for lack of jurisdiction, which some might, like *Premier Tech*. This will clog the courts as neither the court nor the parties will have the benefit of any administrative review of the substantive merits of the refund claim. And moreover, by requiring, as a threshold matter, that a taxpayer produce all the information listed in the IRS Memo, the IRS seeks to have it both ways—it has enough information to evaluate each R&E

Credit refund claim on its merits without starting an audit and risking a waiver of the specificity requirement. Some may say that this is an end run around the waiver doctrine.

Rather than clarifying the application of the specificity requirement in the context of R&E Credit refund claims, the IRS Memo only adds confusion.¹⁰ Substantively, the IRS Memo is in conflict with the *Harper*, *Intermountain Electronics*, and *Premier Tech* decisions. And the fact that it was issued in a Chief Counsel Advice Memorandum before the opportunity for public comment rather than a regulation raises concerns regarding the IRS's compliance with procedural requirements. Considering the substantive and procedural issues, we would expect that the particular articulation of the specificity rule in the IRS Memo to be challenged in court.

Nevertheless, until the IRS Memo is rescinded or successfully challenged in court, taxpayers should claim the R&E Credit on their original returns if at all possible. The IRS Memo applies only to R&E Credit refund claims and claims on original returns are not subject to the onerous information production requirements. If claims cannot be made on an original return, taxpayers should supplement their refund claims, if necessary, as soon as possible. Supplements must be made not only before the statute of limitations expires but also before the IRS rejects the claim as deficient. Finally, while the IRS Memo has roots, in part, in recent court decisions and applies only to claims for the R&E Credit, taxpayers should be on the lookout for the application of this strategy to refund claims for other fact-intensive tax benefits.

The IRS Memo is scheduled to go into effect on January 10, 2022. There will also be a one-year transition period during which taxpayers will have 30 days to perfect a refund claim before the IRS makes a final determination.

ENDNOTES

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¹ H.R. Rep. 97-201, at 125 (July 24, 1981).

² The Economic Recovery Tax Act of 1981, P.L. 97-34, §221, 95 Stat. 172, 241 (Aug. 13, 1981).

³ Code Sec. 6402; Reg. §301.6402-2(b)(1).

⁴ The IRS Memo (defined below) uses the term “reject” to refer to the IRS's decision not to accept a refund claim that it has determined is procedurally deficient and the term “disallow” to refer to the IRS's decision to deny a refund

claim on the merits. We adopt this terminology in this column.

⁵ Code Sec. 7422.

⁶ Code Sec. 41(d)(2)(B).

⁷ *Harper*, 847 Fed. Appx. 408 (2021).

⁸ *Intermountain Electronics, Inc.*, DC-UT, 2021 US Dist. Lexis 133349.

⁹ *Premier Tech., Inc.*, No. 2:20-CV-890-TS-CMR, slip op. (D. Utah, July 15, 2021).

¹⁰ The IRS Memo stands in stark contrast to the IRS position with respect to partnerships subject to

the centralized partnership audit procedures that make adjustments to their originally filed tax returns via amended return rather than an administrative adjustment request. There the IRS will take a more flexible position. It will not immediately reject the improperly filed amended returns but may be more likely to audit such returns relative to properly filed administrative adjustment requests.

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