

Research Credit Claims Audit Techniques Guide (RCCATG): Credit for Increasing Research Activities § 41*

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* Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations.

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INTRODUCTION

Taxpayers are filing claims for the credit for increasing research activities (research credit) under Internal Revenue Code (I.R.C.) § 41 [1] often at the end of an examination cycle, which is requiring the expenditure of additional audit resources often at the expense of other significant audit issues. Research Credit Refund Claims (“RC claims”) have been identified by the Commissioner as a Top Compliance issue for Large and Mid-Size Business Division (LMSB) and are currently designated a Tier I issue. Tier I Issues are of high strategic importance to LMSB and have significant impact on one or more industries.

This Research Credit Claims Audit Techniques Guide (“RCCATG”) provides guidance on how IRS examiners can more efficiently and effectively evaluate RC claims, particularly those that are prepared under the most common approach, Prepackaged RC Claim Studies. This RCCATG discusses the critical factors used to evaluate research credit claims and is designed to assist you in determining if the claim is sufficiently prepared or whether the claim is insufficient to support the credit claimed and requires the issuance of a Notice of Claim Disallowance. This Guide also discusses administrative handling and evaluation of RC claims.

If you determine the claim is sufficiently prepared, please refer to the general [Research Credit ATG](#) for additional guidance on topics such as computations, base period, consistency, and definitions of “qualified research” and “qualified activities”. In addition to the information and references in this RCCATG, the LMSB Tier 1 and LMSB Research Credit websites should be monitored for the latest guidance and developments regarding RC Claims.

CHAPTER I – RESEARCH CREDIT CLAIMS

Background

There is a growing trend among taxpayers, and their representatives, to submit prepackaged material to support research credit claims. These submissions are usually delivered to examiners in multiple binders. While the submissions often set forth the methodology employed in preparing the research credit claim, the submissions frequently fail to substantiate that the taxpayer paid or incurred qualified research

expenses (“QREs”) as claimed. In addition, audits may have been restricted to evaluating the taxpayer's methodology for capturing QREs found in the prepackaged submission, as opposed to examining the research credit claimed on the amended return.

Typical Prepackage RC Claim Study

Research Credit Claim Studies typically include the following three phases of preparation:

1. Initial evaluation. An assessment of issue feasibility is conducted to determine whether a taxpayer is entitled to the research credit, or, if already reported on the return, whether the taxpayer is entitled to additional credit. This information is used to develop a plan for proceeding (or not) to phase two of the study. An engagement letter may be prepared before the feasibility assessment and then updated or revised based upon the findings of the study.
2. Execution of the study plan. Procedures typically performed consist of requesting, reviewing, and compiling accounting records; securing and reviewing the corroborative evidence that is still available; physical inspection of some operations; and conducting employee interviews at various levels within the taxpayer's organization. Questionnaires or surveys may also be employed in this process.
3. Compilation of findings. The documentation is compiled and organized for submission to the IRS. The claim or amended return is prepared and presented to the taxpayer. Computational workpapers are prepared and finalized summarizing the findings of the taxpayer's analysis.

Information in the binders can vary from a simple W-2 analysis to a study containing some or all of following:

- Summary Report, which provides background on the company and the general nature of the research activities.
- Methodology Report, which explains the taxpayer's research study approach for evaluating the issue.
- Departmental Reports, which explain each reviewed department's activities.
- Project Reports, which describes projects, and details why and to what extent qualified research exists.
- Spreadsheets and workpapers reflecting credit computations, departmental cost summaries, project costs summaries, and individual employees' qualified and non-qualified activity allocations. QREs will be summarized and classified in wage, supply, and contract research categories.

Potential Problems

Nexus

Section 41 does not contain a specific requirement that a taxpayer capture the costs of research under a particular approach or accounting methodology. However, § 41 requires the taxpayer to identify qualified research expenses (QREs) by business

component (qualified activity). It is essential that whatever method or approach is used by the taxpayer, it must meet this requirement in order to establish its entitlement to the research credit. A significant number of RC claims are prepared using a hybrid method that does not properly establish the required nexus between QREs and qualified research activities (QRAs). Also, most accounting systems contain information to identify and measure expenditures without considering whether research and development activities meet the statutory requirements under § 41.

Since project based accounting captures research costs at the “business component” level, it generally establishes the required nexus, whereas cost center accounting does not always provide the nexus between qualified activities and their related costs. Taxpayers have employed a number of methodologies in reconstructing the amount claimed for the research credit. Most RC studies reflect a combined hybrid approach. The hybrid method may be a combination of Project and Cost Center methods, adopting portions of each approach for which records are most easily available. The manner in which the information is compiled typically does not support the relationship between the accounting records and the research activities or QREs. Studies lacking this relationship have failed to establish nexus, and therefore are not auditable. In other words, the nexus problem is the inability to connect specific research project(s) and the underlying activities to the qualified expenses.

A common example of the hybrid/nexus problem is in the case of qualified wages established by capturing W-2 wage amounts by cost center and multiplying a qualified percentage to individual employee’s wages or department total wages. The determination of the “qualified” percentage is based on a selected manager’s recollection or estimate of the amount of time particular employees devote to qualified activity, excluded activity, or other nonqualified activities. These managers/employees are sometimes referred to as Subject Matter Experts (SMEs). They may or may not have worked in the areas or performed services for the taxpayer during the years for which they will be opining. These representations may or may not be supported by measurable corroborative records. In some instances, taxpayers may not even apply percentages at the employee level. Rather, a single percentage is determined and applied to total department wage costs.

Arbitrary and unsupported allocations should not be accepted. These are merely estimates and are not sufficient to support a claim. Allocation percentages applied to expenses associated with qualified research activities may be accepted only when the appropriate prerequisites for applying such an approach have been met.

Substantiation - The Eustace Case

The Tax Court discussed the requirements for properly substantiating a research credit claim in **Eustace v. Commissioner**. T.C. Memo 2001-66, aff’d 312 F.3d 1254 (7th Cir. 2002). **Eustace** presents a typical research credit claim involving an accounting firm study and a prepackaged submission. The taxpayer in **Eustace**, Applied Systems did not claim the research credit on its originally filed returns for 1990-1992. Applied Systems thereafter hired a new tax manager who filed claims for 1990-1992 on amended returns. Applied Systems had 5 departments and 450 employees. The tax manager interviewed some employees and prepared a worksheet to “list the salaries” of

the 227 employees that he thought qualified for the credit. At trial, the taxpayer offered the testimony of six employees as to the nature of their activities. The Tax Court found the taxpayer's reconstruction of qualifying expenses to be "unreliable, inaccurate, incomplete, and wholly insufficient." The Court found the pro-forma "list of salaries," supplemented by testimony as being insufficient for the taxpayer to meet its burden of proof. Sufficient evidence was not presented to demonstrate that the salaries were paid for qualified research activities.

The Tax Court in **Eustace**, held that the taxpayer was required to tie salaries to qualified activities at the subcomponent level. Furthermore, the Court refused the taxpayer's invitation to make a "reasonable allocation of salaries to the activities." The taxpayer must show what expenses it paid or incurred in the performance of qualified research activities. The Court denied the taxpayer the ability to apply the Cohan doctrine (See **Cohan v. Commissioner**, 39 F.2d 540 (2d Cir. 1930)) in arriving at an estimate for its QREs and stated that the rule of **Cohan** did not require the Court to make an allocation (of salaries to functionality).

280C Issues

Section 280C(c)(1) provides that no deduction shall be allowed for that portion of the qualified research expenses or basic research expenses (as defined in § 41(b)) or basic research expenses (as defined in § 41(e)(2)) otherwise allowable as a deduction for the taxable year which is equal to the amount of the credit determined for such taxable year under § 41(a).

Section 280C(c)(3)(A) provides that in the case of any taxable year for which an election is made under § 280C(c)(3), § 280C(c)(1) and (2) shall not apply, and the amount of the credit under § 41(a) shall be the amount determined under § 280C(c)(3)(B). The amount of the credit under § 280C(c)(3)(B) for any taxable year is the amount equal to the excess of the amount of credit determined under § 41(a) without regard to § 280C(c)(3), over the product of the amount of credit determined under § 41(a) without regard to § 280C(c)(3), and the maximum rate of tax under § 11(b)(1).

Under § 280C(c)(3)(C), the election shall be made not later than the time for filing the return of tax for such year (including extensions), shall be made on the return, and shall be made in such manner as the Secretary may prescribe. Once made, the election is irrevocable.

Section 1.280C-4(a) provides that the election under § 280C(c)(3) to have the provisions of § 280C(c)(1) and (2) not apply shall be made by claiming the reduced credit under § 41(a) determined by the method provided in § 280C(c)(3)(B) on an original return for the taxable year, filed at any time on or before the due date (including extensions) for filing the income tax return for such year.

A taxpayer should be treated as having made a valid reduced credit election under § 280C(c)(3) if it clearly indicates its intent to claim the reduced credit on its timely filed original return for the taxable year. For guidance in determining if a valid § 280C(c)(3) election has been made, please refer to the [Generic Legal Advice Memorandum](#) issued on Section 280C(c)(3) - Guidance on Reduced Credit for Increasing Research Activities,

dated January 31, 2008 (the "GLAM"). The GLAM provides an example where a valid election is made on the Form 6765 attached to a timely filed original return. Once made the election is irrevocable.

If it is determined that the election is invalid, see the [LMSB Industry Directive](#) on Amended Returns/Refund Claims Containing Invalid I.R.C. § 280C(c)(3) Elections, dated August 26, 2005.

Where such an invalid election is identified, the examiner shall bring this issue to the taxpayer's attention and afford it the opportunity, if available, to further amend its amended return or claim for refund by properly recomputing its research credit under § 280C(c)(1) and (c)(2). Such an amendment must comply with the specific requirements for such claims. See [Notice 2008-39](#). Regardless of whether the amendment is a claim for refund or the reporting of research credit to be carried back or forward under § 39, the Team Manager shall direct the taxpayer to file an amended return with the Ogden Service Center, at the address set forth in Notice 2008-39, with a copy to the Team Manager to expedite any examination of the return. If a taxpayer fails to properly amend a claim for refund to comport with the requirements of §280C(c)(3), the claim shall be disallowed.

IRC 280C Preparer Penalty Issues

LMSB is aware of tax returns and studies, prepared by practitioners, that contain invalid § 280C(c)(3) elections. Depending upon the facts of a particular case, penalties for such conduct may be applicable. **See**, §§ 6694 and 6701. Questions concerning the applicability of such penalties, as well as procedures to be followed in such cases, should be referred to a Research Credit Technical Advisor ("RCTA").

Scope of Examination – Original Return vs. RC Claim

When a taxpayer or accounting firm amends the research credit reported on an original filed return, the approach will be either to evaluate the whole credit or just evaluate the QREs or activities claimed in addition to what was claimed on the original return. You should ask the taxpayer to explain the reason for filing the amended return, and how it was prepared. For example, the reason could be to correct an omission from the original return or the claim could be the product of a marketed study.

- If there is a change in the overall approach used to compute the whole credit, ask the taxpayer to reconcile the claim with what was claimed on the original return. Without this reconciliation to the credit previously filed, the scope of the examination should include all credit amounts, and consideration for "netting" original credit amounts against the overall claim amount should be avoided.
- If the taxpayer's approach is limited only to additional credit, then the scope of the examination may be limited to those additional expenditures claimed.
- If the taxpayer did not claim the credit on its original return, then the entire credit will be considered for examination.

CHAPTER II – Audit Techniques for Examining RC Claims

Evaluating RC Study Based Claims

Once the RC claim has been filed, a determination has to be made as to whether the taxpayer's methodology and substantiation supports the amount of research credit claimed.

Issuing the Mandatory Information Document Request (IDR) Questionnaire

The first step is to determine the quality and adequacy of the taxpayer's claim. A general assessment of any prepackaged information should be conducted after reviewing the Tier 1 directives and guidance. This guidance, found on both the RC website and the Tier I website, currently requires the issuance of a mandatory IDR for all research credit claims that are in the early stages of examination. The Mandatory RC Claim IDR ("RC claim IDR") at the exhibits section at the end of this guide should be used as the initial IDR in examining the taxpayer's RC Claim.

This IDR provides a general inquiry regarding the availability of reliable records, and the taxpayer's method for using records and other means to determine whether expenses and activities meet the qualification criteria. Understanding the method that the taxpayer used to prepare the claim is an essential step in examining the research credit claim. The sequence of questions focuses on specific compliance areas. The taxpayer's response to the questions will assist you in assessing whether the taxpayer can support its claimed credit, including support of the incremental nature of the research credit.

In some instances you and the RCTA may determine that the amount claimed is not adequately supported and should not be considered for further examination and a Notice of Claim Disallowance should be issued. In other instances, the responses to the mandatory IDR will identify the issues that you will need to focus on and will assist you in developing an audit plan. If the taxpayer's claim needs to be perfected either because of legal deficiencies or if it relies too heavily on high level estimations (i.e. interviews, estimates, judgment sampling, etc.), then you should consider disallowing the claim or returning it to the taxpayer to be perfected. Generally, Compliance should only audit claims that comply with the requirements of a valid claim for which taxpayer has adequate substantiation to support the full refund amount being claimed. Based upon the taxpayer's answers to the RC claim IDR, follow-up IDRs can be crafted on an individual basis and you will be able to plan an audit strategy that is appropriate to the taxpayer's unique business circumstances.

To the extent that the records necessary to substantiate the RC claim are among the documents and other information gathered through the taxpayer's RC study (i.e. within the taxpayer's prepackaged "binder" material), the taxpayer should specifically reference and direct you (in response to the questions posed in the mandatory IDR) to the relevant information within the binders rather than have you try to discern the relevance of the binder material yourself.

How to evaluate taxpayer's responses to the RC Claim IDR/Questionnaire

Because RC Claims are a Tier I issue and the issuance of the RC claim IDR is mandatory, you are required to consult with a RCTA to evaluate the taxpayer's response to the IDR questionnaire. The RC claim IDR is designed to focus on significant compliance areas which are discussed below.

Consistency and Base Period Issues

Consistency and Base Amount issues should be addressed. Review the base amount computations for taxpayers utilizing the "regular" RC method. Since the § 41 research credit is incremental in nature, the accurate determination of the base amount for purposes of computing the credit is crucial. It is not enough to show there have been research expenditures; it must be shown that there has been an increase in research expenditures. Taxpayers frequently use extrapolation methods to compute not only the amount of qualified research expenses in the base years but also the amount of gross receipts in these years. Extrapolation is not an acceptable method for computing the "fixed-base percentage." It is also not permissible to use "trending" to determine the amount of qualified research expenses and/or gross receipts in the credit years in arriving at an amount for the base years. Taxpayers are required to maintain records that enable them to delineate accurately the amounts expended for research. See Treas. Regs. § 1.41-4(d) and 1.6001-1; *Research, Inc. v. U.S.*, 76 AFTR 2d 95-5688 (D.Minn. 1995).

The consistency rule is required by the Code and is not affected by the statute of limitations because any proposed adjustment affects only the credit year, not the credit in the base years. Section 41(c)(5)(A) provides that the QREs taken into account in computing the fixed base percentage must be determined on a basis which is consistent with the determination of qualified research expenses for the credit year, regardless of whether the period for filing a claim for credit or refund has expired for any taxable year that is taken into account in determining the fixed base percentage. To satisfy this consistency requirement, the taxpayer must show consistency between the QREs in the credit year and its QREs during the base years. The consistency rule is intended to ensure that there is an accurate determination of the relative increase in QREs over the amount typically spent by the taxpayer. The increase will be accurately measured only if the taxpayer includes the same type of expenses in the credit computation for both the base years and the credit year. This rule would not be met where the taxpayer failed to include a particular type of expense in the base period but included the expenditure in the credit year computations, thus distorting the true increase in qualified research expenses.

In **Research Inc.**, the taxpayer was denied the research credit because it could not quantify the base period research expenses attributable to its "special system projects." The expenses associated with these special projects were included in the credit year and the taxpayer admitted that it incurred the same type of expenses in the base period. The taxpayer could not, however, determine the amount it incurred in the base period because it had destroyed the relevant documentation. The Court disallowed the credit because the relative increase in qualified research expenses could not be measured without considering the expenses incurred during the base period for the same type of projects included in the credit year.

While **Research, Inc.** applied the three year rolling average base period under former § 30(c), its rationale still applies to the current base period rules under § 41(c) which requires a similar increase in the QREs in the determination year over the base amount. If the taxpayer cannot prove their fixed-base percentage, a complete disallowance of the research credit is required, even though the maximum fixed base percentage of § 41(c)(3)(C) is 16 percent. In practice, putting the taxpayer to the maximum 16% fixed-base percentage would likely operate to completely disallow any claimed research credit.

For those taxpayers who do not have adequate records to establish their fixed-base percentage and/or taxpayers who cannot meet the incremental hurdle of the regular method, there are two alternative methods available to compute the research credit. The first is the Alternative Incremental Credit for tax years beginning after June 30, 1996. Treas. Reg. § 1.41-8(b)(2) requires that the election be made on a timely filed original return and cannot be made on an amended return. The second method is the Alternative Simplified Credit, which is effective for tax years beginning after December 31, 2006.

Substantiation- Estimations, Sampling, Oral Testimony

Information to prove or support the claim should be contemporaneous and available for inspection. This includes substantiation in support of all the essential elements of the credit, such as whether for each new or improved business component, taxpayer can prove how that business component meets all of the tests under § 41(d)(1), including the process of experimentation test. The amount and type of documentation that the taxpayer has available will determine how you should proceed with the examination. The extent of the taxpayer's reliance on oral testimony and/or estimations, and not documentation, will also heavily impact on how you should proceed. You should consider whether oral testimony was from employees who actually performed the qualified research and how much time elapsed between the research and the testimony. Since a taxpayer is required to keep records to support the credit under § 6001, the Service does not have to accept either estimates or extrapolations.

Statistical Sampling

The taxpayer must be able to support 100% of the research credit being claimed, unless the taxpayer uses a valid statistical sample to determine its qualified research activities and expenses.

Non-statistical sampling, commonly referred to as "judgment sampling", possesses none of the scientific safeguards inherent in statistical sampling. The only assurance of accuracy stems from the judgment of the sampler. The projection of results from non-statistical sampling would only be correct by pure chance. There is no authority that allows taxpayers to use a judgment sample to compute the research credit. Taxpayers would be entitled to the credit only on the activities or expenses that they substantiated from the sample. Any activities or expenses not substantiated should be disallowed.

Additional Areas to Consider

Please consider the following points when evaluating the responses to the RC claim mandatory IDR:

1. **Contingency Fees** - If the fee is based on the ultimate determination of the claim amount there may be a limitation on to ability of the taxpayer to resolve the issue. Some fee agreements shift ultimate control over the resolution of the claim to the preparer.
2. **280C Elections** - A section 280C(c)(3) election cannot be made on an amended return. A claim with an invalid election should be returned to the taxpayer to be perfected. The Service Center might not catch this error, so that it is essential that it be verified by the agent. See [Industry Directive](#), dated August 2005, for additional guidance on claims with invalid § 280C(c)(3) elections.
3. **Group Credit** - Is the taxpayer a member of a group of entities under common control (which is defined as greater than 50% control)? Sections 41(f)(1) and (f)(3) require common control members to aggregate their QREs and to compute and allocate the group credit as if they were a single entity. A RC Claim filed by any member could affect the credit allocable to the other members.
4. **Cost Capturing Methods** - How are the qualified costs captured? The methodology used and how it connects QREs to the taxpayer's books and records will give you a sense of how to proceed. Though a project methodology is not a requirement for the credit, it will usually provide an accurate measurement of QRAs and will provide the direct nexus with the QREs, the essential elements of qualifying for the credit. Other cost capturing methodologies may not establish the required nexus between the qualified activities and expenses, and may not be sufficient to meet taxpayer's recordkeeping requirements under § 6001. If the taxpayer maintained a project methodology and did not use it in claiming the research credit, ask why it was not used. It may be the best methodology for you to use in auditing the RC claim.
5. **Additional research expenses** - Consider how the taxpayer treated the additional claimed research expenses in the claim on its original return, and whether the treatment of the expenditures in the claim is an unauthorized change of accounting method.
6. The definition of QREs does not include overhead or indirect expenses. Question whether any overhead or indirect expenses were included in the claim.

Evaluating Information

Based upon an analysis of the taxpayer's records, you should be able to make an assessment of the validity of the taxpayer's claimed QREs. In analyzing the taxpayer's records, consider the following:

- Are the records competent evidence that is valid and relevant to the QREs and QRAs?
- Are the records complete - are all transactions addressed to adequately substantiate the claim?
- Is additional corroborative information necessary to assess the correctness of the claim?

Remember that the credit involves the verification of both research costs and research activities and the cost to activity nexus is often difficult to establish. When taxpayers use

a cost center or hybrid approach, and QREs are generally not traceable to a specific business component (research projects/activity), disallowance of part or the entire cost center may be appropriate if:

- all or part of the activities undertaken in the cost center did not involve qualified research activities;
- all or part of the expenses claimed in the cost center as QREs were not qualified expenses;
- the taxpayer's sole basis for substantiating the qualified activities of the cost center was estimates; or
- the basis for allocating qualified or non-qualified activities or expenses is arbitrary or there is insufficient corroborative evidence to support the allocation.

If it is determined that the RC claim should be disallowed based upon the answers to the RC claim IDR, or subsequently issued follow-up IDRs, a claim disallowance notice should be issued. Disallowance notices and template letters, which can be tailored to an individual case, can be found at the back of this guide. The following language may be used in the disallowance notice as the reason for the disallowing the claim:

Consideration has been given to your claim for refund filed on _____, for additional research credit in the amount of \$_____. It is determined, however, that this claim is not allowable because it has not been established that you satisfy the requirements of the Internal Revenue Code that must be met in order to establish entitlement to the research credit.

Audit Reports

For unagreed cases, it is of utmost importance that your audit report discuss all inadequacies of the RC claim, including taxpayer's non-compliance with § 6001. If the RC claim lacks sufficient substantiation, such as inadequate contemporaneous documentation, the insufficient substantiation should be clearly stated in the report. Sample language for substantiation disallowance write-ups are being prepared by the RCTA team and will be added as Exhibit E to this guide in the near future.

If there are alternative issues identified as a result of the examination, then it is recommended that you prepare a separate Notice of Proposed Adjustment (NOPAs)/5701s, describing the facts and legal arguments for each issue, including a discussion of taxpayer's compliance with § 6001. Coordinated issue positions should be clearly cited.

Audit reports (F-886A) should clearly: (1) summarize the per return and additional claim amounts; (2) state the amount allowed per audit; (3) describe the examination procedures employed and conclusions reached; and (4) explain your attempts to request appropriate information and documentation. The facts for each audit report should be clearly and concisely listed and discussed. If the taxpayer's methodology under the RC claim study is unreliable, then the audit report should indicate where and why the methodology is unreliable. All written protests received from taxpayers should be rebutted "in writing" by the examiner. You should always write a rebuttal to

taxpayer's protest ensuring that all representations in the protest are properly addressed. The rebuttal is crucial; even if you simply state that no new arguments were raised. In addition, the Report Transmittal (T-letter) should alert the Appeals Officer that the case is a Tier 1 research credit claims substantiation case.

The RCTA team may be able to assist in providing legal position write-ups for emerging issues and will review and comment on NOPAs before they are issued to the taxpayer.

Closing agreements, as well as, non-statutory agreements should be reviewed and approved by Area Counsel before commitments between you and the taxpayer are finalized.

RC Claim Examination Tools

- **General ATG**

Once a determination to examine the claim is made, refer to the general Research Credit Audit Techniques Guide for additional guidance pertinent to all research credit examinations, including RC claims.

- **Exhibits**

The exhibits included at the end of this guide also provide quick reference information related to the Research Credit. These include:

- Exhibit A Research Credit Claim Checklist
- Exhibit B Limitation Periods for filing Research Credit Refund Claims
- Exhibit C Mandatory Research Credit Claims IDR
- Exhibit D Computation Check Sheet
- Exhibit E Reserved for Pro-forma Substantiation Write-up
- **Information Document Requests (IDRs)**
 - Sample IDR questions can be found on the Research Credit webpage. Document requests should be tailored for the taxpayer by cutting and pasting only the applicable IDR questions.
- **The RC Claim Engagement Letter**

RC Claims are usually based upon a Research Credit Study prepared by an outside consultant. The outside consultant conducts the study pursuant to an "engagement letter." An IDR requesting a copy of the engagement letter should be issued along with the RC Claim mandatory IDR. If the taxpayer refuses to provide the engagement letter, consider issuing a summons to obtain it. Obtaining the engagement letter is important for three reasons:

1. The engagement letter provides valuable insight into how the consultant conducted and prepared its Research Credit study. Most engagement letters describe how the consultant will conduct its RC study, including details such as, a description of each

phase of its study, the names of the consultant employees conducting the study and individual tasks to be performed. The engagement letter may: discuss whether and how taxpayer employee interviews will be conducted; provide a list of the records the taxpayer is requested to make available; provide a list of the research activities the consultant is to analyze and why such analysis is important; provide a list of the specific work products the consultant will create; and discuss the extent to which the consultant will analyze the base years. This information will help you identify issues and assist you in preparing focused IDRs.

2. The engagement letter will assist in determining whether the taxpayer entered into a reportable transaction pursuant to § 1.6011-4 (i.e. Confidential Transactions, § 1.6011-4(b)(3); Transactions with Contractual Protection, § 1.6011-4(b)(4)). Failure to properly disclose a “reportable transaction”, by filing a Form 8886 in accordance with Treas. Reg. § 1.6011-4(d), may subject the taxpayer to a penalty pursuant to I.R.C. § 6707A.
3. The engagement letter will also assist in determining whether the advice provided under the engagement is a Covered Opinion. A contingent-fee engagement may be a Covered Opinion as defined under Circular 230, § 10.35(b)(7). Any Covered Opinion that fails to reach a “more likely than not” conclusion is required under § 10.35(e)(4) of Circular 230 to disclose that the opinion can not be used by the taxpayer for the purpose of avoiding penalties.

If you suspect that a penalty issue exists, contact local Counsel for assistance and notify the RCTAs. Also, see Chapter III, “Penalty Regarding Erroneous Claim for Refund or Credit” for a discussion of the § 6676 penalty.

Supplemental contracts entered into for the engagement should also be requested. This information is not privileged and Counsel can assist with summons enforcement if needed.

- **Website info**

For more information on research credit including RC issues and available resources, please visit the RCTA website or IRS.gov.

CHAPTER III – ADMINISTRATIVE CONSIDERATIONS

Mandated Issue Tracking Codes

In order to better identify and analyze the patterns, trends and compliance impact of the R&E Credit Claim Issue, the following issue tracking procedures are now required on all open examinations which have either formal or informal RC claims (i.e. in-process and new RC claim examinations). LMSB Team Managers and Revenue Agents must adhere to the following:

1) On ERCS, Tracking Code 0551 and Project Code 0551 are required to be manually input on all RC Claims at the examination level.

2) On IMS, you need to accurately complete the 'Issue Details' screens. This includes input of the SAIN code, UIL code, Issue Tracking Attribute and 'Adjustment Source' information,:

- Identify the proper UIL code. There are numerous UIL codes for R&E issues ranging from 41.00-00 to 41.55.09. You should select a '41 series' code related to the most significant issue on the R&E Credit Claim.
- Complete the 'Adjustment Source' screen to identify the type of claim, either 'formal' or 'informal' and any additional claim information.

Penalty Regarding Erroneous Claim for Refund or Credit

The U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007 (the "Act") signed by the President on May 25, 2007, added a new penalty for the filing of an erroneous refund claim. This new penalty, under § 6676(a), provides that if a claim for refund or credit with respect to income tax is made for an excessive amount, then unless it is shown that the claim for such excessive amount has a reasonable basis, the person making such claim shall be liable for a penalty in an amount equal to 20 percent of the excessive amount.

For purposes of § 6676, the term "excessive amount" is the amount by which the amount of the claim for refund or credit for any taxable year exceeds the amount of such claim allowable under the Code for such taxable year. § 6676(b).

The penalty imposed by § 6676 does not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under the Accuracy Related or Fraud Penalties. §6676(c). It also does not apply to the earned income credit. § 6676(a)

The erroneous claim for refund penalty applies to any claim, not just research credit claims, filed or submitted after May 25, 2007. To ensure consistent treatment of this penalty on erroneous research credit claims, all examination teams are required to determine if the penalty is applicable or not and obtain concurrence from the Issue Owner Executive through the RCTAs.

Refund Claim Requirements

Section 6402 provides that the Secretary (within the applicable period of limitations), may credit the amount of an overpayment of tax, including interest, against any internal revenue tax liability of the person who made the overpayment and shall refund the balance to the person. Section 6511(b)(1) provides that no refund may be allowed or made after the expiration of the period of limitation for filing a claim for refund unless a claim for refund is filed by the taxpayer within such period. Generally, the period of limitation under § 6511(a) for filing a refund claim is three years from the time the return was filed or two years from the time the tax was paid, whichever is later.

The Procedure and Administration Regulations identifies the following general requirements that must be satisfied for the filing of a proper refund claim:

(1) with certain exceptions, (which include RC claims), the claim must be filed with the service center where the tax was paid (§ 301.6402-2(a)(2)); however pursuant to Notice 2008-39 , all 1120 corporate taxpayers are required to file their research credit claims with the Ogden Service Center;

(2) the claim 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 thereof (§ 301.6402-2(b)(1));

(3) statement of the grounds and the facts must be verified by a written declaration made under the penalties of perjury (§ 301.6402-2(b)(1));

(4) in the case of an overpayment of income taxes for a taxable year of a corporation for which a Form 1120 has been filed, a claim for refund shall be made on Form 1120X ("Amended U.S. Corporation Income Tax Return") (§ 301.6402-3(a)(3)); and

(5) a separate claim is to be made for each taxable year or period (§ 301.6402-2(d)).

If a taxpayer fails to satisfy these requirements and the IRS does not waive the issue, a taxpayer's claim will not be treated as a claim for refund under I.R.C. § 7422.

Notice 2008-39 Credit for Increasing Research Activities: Filing Address and Requirements for Certain Claims for Credit of Refund

[Notice 2008-39](#) reiterates the current IRS position that corporate refund claims involving research credits must generally be filed at a central address. This Notice eliminates a prior approach (Notice 2002-44) allowing taxpayers under audit to submit (with IRS approval) certain research credit claims directly to IRS auditors.

Rev. Proc. 94-69 provides special procedures for taxpayers that are subject to the Coordinated Examination Program ("CEP") to make adequate disclosure with respect to an item or a position on their original return. However, if taxpayer is claiming additional research credit, this disclosure statement does NOT relieve taxpayer of the requirement to file a formal research credit claim with the Ogden Service Center as set out in Notice 2008-39.

Claim Filing Considerations

- **Requesting a Refund - IRM 4.11.11.9 (5-13-2005)**

Taxpayer's filing of a claim for refund allows the IRS to examine the return that is the subject of the refund claim and the year from which the claim originated. You should review the claim issue, as well as all other material tax issues for the refund return year to determine all potential adjustments that could be made. Even if the period for the assessment of a deficiency for the year of the claim has run, the IRS can still make

adjustments that reduce the amount of the refund and also make adjustments to a carryover or continuing item that affects other return years. The various periods of limitations for filing refund claims are summarized in the exhibits found at the end of this guide.

- **Business Credits - IRM 4.11.11.8.1 (5-13-2005)**

Research credits are limited to the tax liability (with certain adjustments), and any credits in excess of the tax liability are subject to the carryback and carryforward provisions of Code § 39. Since the carryback of a net operating loss (NOL) usually reduces the tax liability for the prior year, allowable credits in the prior year will be affected. In such situations, the NOL takes precedence over the business credits. Thus, if the carryback of a NOL creates unused business credits in the carryback year, the General Business Credit (which includes the research credit) is carried back one year (for taxable years beginning after 12/31/97). The statute of limitations for the credit carryback will be governed by the year in which the NOL arose. I.R.C. § 6511(d)(4).

- **Form 1120X Amended Return (claiming a refund of an overpayment)**

No refund or credit can be made unless it has first been determined that the taxpayer has made an “overpayment” of tax for the return year. Tax payment(s) that exceed the amount correctly due for a year creates an “overpayment.” “Refundable credits” (e.g. earned income credit) are included in what is considered overpayments of tax. However, the Research Credit is a non-refundable credit.

While the Service may, within the applicable statutory period of limitations, credit the amount of a taxpayer’s overpayment against any tax liability that the taxpayer may have and refund the balance to the taxpayer, such credit or refund cannot be made unless a “claim” for refund is filed by the taxpayer. § 6402(a) and § 6511(b)(1).

A refund claim is considered filed timely if it is filed within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever period expires later. § 6511(a). If an extension of time for assessment has been entered into pursuant to § 6501(c)(4), within the period prescribed for filing a refund claim, the period for filing the claim will not expire prior to 6 months after the expiration of the extended assessment statute. § 6511(c)(1).

Generally, the amount of a credit or refund is limited to the amount of tax paid within the period, immediately preceding the filing of the claim, equal to 3 years plus the period of any extension of time for filing the return. § 6511(b)(2)(A). If the claim is not filed within the 3 year period, the amount of the credit shall not exceed the portion of the tax paid during the 2 years immediately preceding the filing of the claim. § 6511(b)(2)(B).

- **Form 1120X Amended Return (no claim for refund of an overpayment)**

An “amended return” that does not claim a refund based upon an overpayment of tax for the return year is not a “claim for refund.”

While many practitioners refer to an amended return as a “claim” if the amended return reflects an increased NOL, increased general business credit (“GBC”) or increased carryback/carryforward of an NOL or GBC, such an amended return is not a “claim for refund” unless the increase in the NOL or GBC results in an overpayment for the year.

Amended returns can also be filed to simply reflect additional tax due for a year.

- **Form 1139 Tentative Overpayments: Tentative Carryback Adjustment under I.R.C. § 6411**

Because of the length of time it takes the Service to audit claims for refund, a taxpayer may be entitled to a quicker refund by filing a Form 1139, Corporation Application for Tentative Refund pursuant to § 6411. A taxpayer may file a Form 1139 for a tentative carryback adjustment of the tax for a prior taxable year affected by a NOL, GBC or capital loss carryback. The application for a tentative refund does not constitute a “claim for credit or refund.”

- **Joint Committee Coordination**

No refund or credit of any income tax can be made in excess of \$2 million until after the expiration of 30 days from the date upon which a report is given to the Joint Committee on Taxation. The report contains the taxpayer’s name, the amount of the refund or credit and a summary of the facts and decisions of the Secretary. I.R.C. § 6405(a). The Joint Committee on Taxation is a permanent committee established by Congress to monitor taxation issues, one of its responsibilities being to review refunds or credits of the jurisdictional amount.

A refund or credit subject to Joint Committee reporting can arise from either an examination or the Service Center forwarding to the field unpaid claims or tentative allowances in excess of \$2 million. The examiner is responsible for determining whether a case falls under Joint Committee jurisdiction. See I.R.M. 4.36 for Joint Committee procedures for refunds in excess of \$2 million.

- **Late Cycle Claims**

Some taxpayers attempt to use a strategy of filing informal RC claims near the end of an audit cycle in anticipation of additional tax deficiencies which may be assessed for other issues raised in the open examination year(s). Refund claim procedures require that taxpayers establish an “overpayment” in order to file a valid refund claim. A reduction in an “anticipated” tax deficiency (e.g. potential tax audit adjustments) does not establish “overpayment” of tax. In such circumstances, informal claims should not be accepted. You should advise the taxpayer that audit consideration of the alleged claim will not be made until after refundable amount(s) can be established by the taxpayer and formal claim procedures are followed. The examination team should mandate administrative compliance with Notice 2008-39 before pledging any resource commitment to the RC claim issue.

Taxpayers should always be reminded to submit refund claims early in the examination process. Any late filed RC claim should be subordinate to the completion of other examination cycle issues and should not impede or delay timely closing of the open cycle years. If it is impractical to work the examination of the RC claim concurrent with the open cycle, the audit of the RC claim should be deferred to a subsequent examination cycle.

- **Protective and Incomplete Refund Claims**

Protective claims are filed to preserve the taxpayer's right to claim a refund when the taxpayer's right to the refund is contingent on future events and may not be determinable until after the statute of limitations expires. A protective claim is based on an expected change in the tax law, other legislation, regulations, or case law.

A claim should not be viewed as a valid protective claim merely because the taxpayer labels it as such. See **Nucorp, Inc. v. United States**, 23 Cl. Ct. 234, 235 (1991)(Footnote 3 provides "[n]othing can be found in the Code, regulations or case law relative to the efficacy of filing a 'protective claim.' Ostensibly, [taxpayers] used the term 'protective claim' for descriptive purposes only.")

A valid protective claim need not state a particular dollar amount or demand an immediate refund. The claim, however, must identify and describe the contingencies affecting the claim; must be sufficiently clear and definite to alert the Service as to the essential nature of the claim; and must identify a specific year or years for which a refund is sought.

The Service has discretion in deciding how to process protective claims. In general, it is in the interests of the Service and taxpayers to delay action on protective claims until the pending litigation or other contingency is resolved. Once the contingency is resolved, the Service may obtain additional information necessary in processing the claim and then allow or disallow the claim.

Where a taxpayer files a claim for only one dollar or some other de minimis unreasonable amount because the taxpayer's failure to state the actual amount of the claim arises from the taxpayer's failure to compile records, rather than from a stated contingency affecting the amount of the claim, the claim is **not** a "protective claim." The claim is an ordinary claim that is **incomplete**.

If the Service receives an incomplete claim, such as where the requested refund is one dollar, the Service should generally request additional information as to the actual amount of the claim, unless it is clear that the claim must be disallowed. The Service should provide the taxpayer with a reasonable amount of time to supply information as to the actual amount of the claim and other necessary information. If requested information, including the actual amount of the claim, is not provided within a reasonable time, the Service should take final action on the original claim after fully considering all grounds stated for the refund. Thus, in some cases, the claim should be disallowed on the merits. In other cases, it may be appropriate to treat the claim as nonprocessable. Treasury Regulation § 301.6402-3(a)(5) provides that a refund claim must state the amount of the overpayment. The Service may insist on full compliance

with the regulations governing refund claims. See **Angelus Milling Co. v. Commissioner**, 325 U.S. 293 (1945).

Computational Checklist relating to Research Credit Claims

It is important to evaluate the computational accuracy of the taxpayer's calculation of the incremental research credit and the amount of the refund. Since the research credit is an expenditure based credit, the taxpayer's identification of additional "qualified research expenditures" not only affects the allowable credit amount but may correspondingly impact income, deductions, and other tax items in computation of taxable income. When evaluating a research credit claim, you should make sure that the taxpayer made all necessary adjustments to taxable income and the claimed credit to ensure the proper computation of the tax liability before credits and the correct computation of the credit amount, credit utilization, and refund amount.

EXHIBIT D, of this ATG, provides a Computational Checksheet which may be used in conjunction with evaluation of taxpayer responses to the Mandatory IDR. The Computational Checksheet addresses: (1) general research credit computational issues; and (2) potential changes to taxable income and other items resulting from identification of additional QREs. Both items are important in proving the taxpayer's entitlement to a refund of an overpayment pursuant to § 6402.

Exhibits

[Exhibit A Research Credit Claim Checklist](#) (Published 5/2008)

[Exhibit B Limitation Periods for filing Research Credit Refund Claims](#) (Published 5/2008)

[Exhibit C Mandatory Research Credit Claims IDR](#) (Revised 2/2009)

[Exhibit D Computation Check sheet](#) (Published 5/2008)

Letters & Forms

Letter 906 Claims Disallowance

Letter 905 Partial Claim Disallowance

Form 3363 Acceptance of Proposed Claim Disallowance

Form 2297 Waiver of Statutory Notification Claim Disallowance

1. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations.