

More Documentation will be Required to Substantiate R&D Credit Claims in the Future

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The last several years have brought a whirlwind of changes for taxpayers claiming the Credit for Increasing Research Activities (R&D Credit or the credit) under § 41 of the Internal Revenue Code of 1986, as amended (the Code). The R&D Credit is a powerful incentive for companies to conduct research in the United States. Eligible taxpayers can reduce their tax liability dollar-for-dollar based on increased research and development spending. But, recent tax controversy and requirements implemented and proposed by the Internal Revenue Service (IRS) indicate that taxpayers who qualify for the credit should consider streamlining their documentation procedures to ensure that claims can be adequately substantiated.

The R&D Credit is currently the focus of an active audit campaign with the IRS Large Business and International Division (LB&I). In 2021, the Tax Court's decision in *Little Sandy Coal Co., Inc. v. Comm'r*, 121 T.C.M. (CCH) 1113 (T.C. 2021), *aff'd*, 62 F.4th 287 (7th Cir. 2023), and the Seventh Circuit's subsequent affirmation of the Tax Court's ruling in 2023, confirmed that taxpayers claiming the credit need to be ready to prove their claims. Post-*Little Sandy Coal*, IRS examinations of the R&D Credit have increasingly focused on documentation supporting the claim.

On June 21, 2024, the IRS released a new proposed draft of the Form 6765 used to claim the R&D Credit. The proposed draft Form 6765 requires more robust qualitative and quantitative reporting than the current version of the Form 6765. Likewise, the IRS recently updated its guidance for filing amended returns to claim R&D credit refunds, requiring more detailed reporting.

Background

The R&D Credit is calculated based on a portion of the taxpayer's increased qualified research expenses (QREs) incurred in a given tax year. Not all research spend qualifies for the credit. For costs to be eligible as QREs, they must be incurred in the performance of "qualified research."

Qualified research is (1) research incurred in the taxpayer's trade or business, intended to discover information or eliminate uncertainty concerning a business component's capability, method or design, and represents research and development in the experimental or laboratory sense, (2) undertaken for the discovery of information which is technical in nature, (3) the application of which is intended to be useful in the development of a new or improved business component, and (4) substantially all of the research activities must involve a process of experimentation for the purpose of developing a new or improved function, performance, reliability or quality (the Four Part Test). Code § 41(d). The research activities must take place in the United States. Further, the research need not be successful to qualify.

QREs include either in-house research expenses or contract

research expenses. In-house research expenses are the costs of labor, supplies and the right to use computers in the conduct of qualified research. Contract research expenses are amounts paid to any person, other than an employee, to conduct qualified research, reduced by 35%. Code § 41(b).

Little Sandy Coal Company, Inc. v. Comm'r of Internal Revenue

"Taxpayer asks us to take on faith that the percentage allocations of each nonproduction employee's wages were only for research activities that involved a process of experimentation. But Section 41(d) requires us to walk by sight, not by faith."

Little Sandy Coal Co., Inc. v. Comm'r, 62 F.4th 287, 308 (7th Cir. 2023).

The U.S. Tax Court rocked the R&D Credit world with its decision in *Little Sandy Coal*. The taxpayer, a shipbuilder, claimed the R&D Credit for research related to the development of a tank barge and dry dock. The Taxpayer claimed approximately \$6.4 million and \$2 million in QREs related to the tank barge project and the dry dock project, respectively. Additionally, the Taxpayer claimed \$609,276 in QREs that were not associated with a specific project.

While the taxpayer successfully convinced the Tax Court that it had engaged in a process of experimentation, it failed to prove that substantially all of its activities in designing the tank barge and dry dock involved a process of experimentation (thereby failing to meet the fourth prong of the Four Part Test). Further, the Court found that the taxpayer had not produced enough evidence to apply the shrinking-back rule under Treas. Reg. § 1.41-4(b)(2), which allows the Court to revive a R&D Credit claim at the sub-component level where the Four Part Test is not met at the business component level.

While the Tax Court's decision in *Little Sandy Coal* generated a great deal of commentary regarding its implications for what constitutes qualified research and which expenses can be claimed, the Seventh Circuit's affirmation cemented *Little Sandy Coal's* lasting impact on the substantiation of R&D Credit claims. The Seventh Circuit recognized that the taxpayer's "research activities to develop these parts [of the tank barge and dry dock] may very well constitute elements of a process of experimentation. But...[the] Taxpayer's documentation lacks the necessary detail to prove that." *Little Sandy Coal*, 62 F.4th at 303. The Court further cautioned "[o]ther taxpayers seeking to avail themselves of the research tax credit would be well-advised to document research activities for subcomponents if they cannot demonstrate a process of experimentation at the business component level." *Id.*

Proposed Changes to Form 6765

The current Form 6765 is strictly quantitative. Initially, the IRS released a proposed draft Form 6765 in September 2023, adding new sections to the Form that increased the focus on information reporting at the business component level. The latest version, released in response to taxpayer commentary, will keep the new quantitative and qualitative requirements for each business component proposed in the September draft. If implemented, taxpayers claiming the credit on an original return will need to describe the information sought to be discovered and provide a breakout of types of QREs claimed for each business component.

The latest draft scaled back the reporting requirements initially proposed in September 2023. The original draft required all QREs to be reported at the business component level. The new draft only requires a taxpayer to report 80% of its total QREs by business component, with a cap of 50 business components. The business component level reporting requirement is optional for qualified small business taxpayers, meaning taxpayers who check the box for the reduced payroll tax

credit, and taxpayers with \$50 million or less in gross receipts and claiming \$1.5 million or less in QREs.

Claiming the R&D Credit on an Amended Return

In October 2021, the IRS announced a new Chief Counsel memorandum (20214101F) clarifying the information necessary to meet the specificity requirements of Treas. Reg. § 301.6402-2 for claiming a R&D Credit refund on an amended return. The memorandum concluded that a valid refund claim must identify (1) all the business components for which the refund claim is related, (2) the research activities performed for each business component, (3) the individuals who performed each research activity, (4) the information each individual sought to discover, and (5) the total QREs, broken out by wage expenses, supply expenses and contract research expenses by business component for the claim year.

LB&I later released interim guidance and frequently asked questions (FAQs) for applying the memorandum. This summer, the IRS revised its FAQs to eliminate the requirement for reporting the name and information sought to discover for each individual performing the qualified research.

Documentation, Documentation, Documentation

The current regulations governing the R&D Credit do not require taxpayers to keep any specific records pertaining to qualified research. Instead, Treas. Reg. § 1.41-4(d) says "[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," then refers to the general record keeping requirements of Treas. Reg. § 1.6001-1.

Historically, taxpayers have relied on the rule from *Cohan v. Comm'r*, 39 F.2d 540 (2d Cir. 1930) (the *Cohan* rule). The *Cohan* rule is implicated where a taxpayer proves some entitlement to a tax benefit. *Little Sandy Coal*, 62 F.4th at 301 (citing *Shami v. Comm'r*, 741 F.3d 560, 568 (5th Cir. 2014)). Where a taxpayer can establish that qualified research occurs, the qualified research expenses subject to the R&D credit may be estimated. *Id.*

In the future, taxpayers should consider the Seventh Circuit's advice in *Little Sandy Coal*, as well as the IRS's proposed changes for claiming the R&D Credit on an original return and recent guidance concerning the information required to claim a R&D credit refund. The current trend is that more documentation will be needed to claim the credit going forward.

The R&D Credit can be a game-changer for companies with high research costs. An experienced tax professional can help navigate the process and ensure that taxpayers claiming the R&D Credit are ready to defend it, if necessary. Taxpayers claiming the R&D Credit should be ready to show an IRS examiner (and maybe the Tax Court) exactly why they qualify.

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