



Resolving research tax credit controversies

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Today's presenters



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Objectives

By the end of this session, you will be able to:

- Understand the IRS' approach to research tax credit issues
- Prepare documentation and testimony to support the research tax credit
- Understand recent changes in IRS procedures for research credit examinations
- Know when to use methods of dispute resolution to resolve issues and achieve a favorable result

Agenda

Topics

Why the research credit is so taxing

New LB&I procedures—IPGs

Examination of the research tax credit

Dispute resolution of research credit issues

Why are research tax credit examinations so taxing?

Why are research tax credit examinations so taxing?

- Research tax credit calls for a qualitative judgment—does the activity meet the definition of “research?”
- What is the nexus between the business component, research activity and research expense?
- Credit results in a dollar for dollar reduction in federal income tax—can have a significant tax impact
- Because the research tax credit is incremental, IRS has to look at expenses for more than one year

Overview of research tax credit—three steps to calculate a tax credit

- Determine if the activity is a qualified research activity (QRA)
- Identify expenses related to the activity that are qualified research expenses (QRE)
- Calculate the credit by determining an increase in research expenses over the base amount

IRS approach to research tax credit examinations

- Use of IRS engineers, issue specialists
- Use of previously mandatory IDR (IDR Q)
- IRS audit techniques guide on research credit
- Previously treated as a tier one issue

New examination procedures: Issue practice groups (IPGs)

IPGs and the end of tiered issues

- Claims for refund based on research tax credit previously treated as a tier one issue
 - Claims had to be separately filed on Ogden Service Center
 - Claims were subject to rigorous examinations
 - Examiners had to consider section 6676 penalties
- On Aug. 27, 2012, the LB&I commissioner announced the end of the tiered issue process
 - All tier one, two and three issues are no longer tiered
 - Each issue should be risk assessed and examined in the same manner as any other issue
 - Resolution of former tiered issues are now in the hands of the local team handling the examination

IPGs replace tiered issue process

- Issue practice groups
 - New knowledge management strategy
 - Change from single technical specialist (TS) model to a collaborative model
 - Issue practice group for research tax credit
 - Team approach to issues
 - Team members include:
 - The current subject matter TS (who may be the coordinator)
 - Senior auditors who have deep practical experience auditing the subject
 - Counsel dedicated to LB&I
 - Others with expertise in the subject

IPGs and the research tax credit

- Pilot IPG for the Research tax credit
 - IDD no longer apply—now being considered as IPG
 - IRS has 11 pilot IPGs including business credits
 - Questions to consider:
 - Do claims have to be separately filed with IRS?
 - Will mandatory IDR (IDR Q) be issued?
 - Will penalties be assessed under section 6676?
 - What is the role of the technical advisor?

LB&I directive on pharmaceutical drugs

- “Guidance for computing and substantiating the credit for increasing research activities under section 41 of the Internal Revenue Code for activities in developing new pharmaceutical drugs and therapeutic biologics”
- Issued by IRS Large Business and International (LB&I) Division to IRS examiners, Dec. 7, 2012

LB&I directive on pharmaceutical drugs (cont.)

Examiners should not challenge the amount of QREs taken by a taxpayer:

- (i) to the extent that the QREs, within the meaning of section 41(b) of the Code, are for "qualified research" activities that occur during stages one and two of the Pharmaceutical Drug and Therapeutic Biologics Development Process and clinical trials required by the FDA relating to accelerated approvals; and
- (ii) the taxpayer provides the Certification Statement.

LB&I directive on pharmaceutical drugs (cont.)

Significance of LB&I directive

- Stage one (pre-clinical) and stage two (clinical) research are agreed research activities—IRS will not do a detailed analysis of activities in these phases
- IRS will accept taxpayer's calculation of research expenses in phase one and two upon certification—no need to further document
- LB&I directive takes a practical industry approach to research activities and expenses—shows positive impact of IPGs

Examination of the research tax credit

IRS examination—the opening conference

Establish an examination plan

- Identify the issues to be examined
- IRS personnel involved
- Time frame for field work
- Handling procedural matters
- Communication with team manager

Examination of the research tax credit

- If a research tax credit study was prepared—go through it with the IRS
- Go over the research credit calculation with the IRS including base amount
- Conduct a facilities tour with IRS examination team
- Discuss substantiation acceptable to IRS
- Discuss possible interviews and procedures

Substantiation

- Time records—preferred by IRS but can be unreliable
- Surveys—may be accepted by IRS but need supporting documentation
- Project accounting—acceptable but may undercount wages
- Process of experimentation—documentation that shows process, failures and modifications

Interviews

- Interviews of key research personnel can supplement other evidence
- Thoroughly prepare for interviews—interviewees should be familiar with tax rules and what to expect from IRS
- Set ground rules with IRS
 - How long?
 - Who's participating?
 - Are there specific projects to be addressed?
 - What documents may be referenced?

Resolving the research tax credit examination

- Involve the revenue agent and team manager
 - IRS engineers act as consultants to the exam team—final decisions rest with lead revenue agent and team manager
- Ask for a notice of proposed adjustment (5701)
 - Make the IRS specify what part of the credit claim (activities, expenses, computation) the IRS is challenging
 - A blanket disallowance doesn't help the taxpayer
- Has the agent/engineer received outside assistance?
 - Ask if counsel or others were advising and talk to them directly

Dispute resolution techniques for the research tax credit

Dispute resolution using IRS appeals

- Fast track settlement
- Appeals resolution of 30 day letter
- Using delegation orders to settle later years

Fast track settlement

- Rev. Proc. 2009-44
- Notice of proposed adjustment required
- Appeals officer acts as mediator to reach a settlement
- Mediation session may be informal trial on the merits—prepare documents and witnesses
- Can still resolve through 30 day letter

Traditional appeals resolution

- Appeal of 30 day letter from examination
 - Must be specific—Goertz v. U.S.
- Independent review by appeals—no exam involvement
- All factual material must be in the examination file
- Appeals mediation may be available

Using delegation orders

- Delegation Order 4-25 for coordinated issues
- Delegation Order 4-24 for coordinated industry cases

Delegation orders allow taxpayers to settle subsequent years consistent with appeals settlement

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