

# The Government's Use of Procedural Hurdles to Disallow Research Credit Refund Claims

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In two recent cases, the IRS has tried to defeat research credit refund claims on procedural grounds, rather than simply litigating whether the substantive nature of the asserted research meets the requirements of section 41 of the Internal Revenue Code. *Premier Tech, Inc. v. United States* (Fed. Dist. Ct. Utah, July 15, 2021) and *Intermountain Electronics, Inc. v. United States* (Fed. Dist. Ct. Utah, July 16, 2021) are recent cases discussing the procedural challenges. The cases were both decided in the federal district court in Utah, one day after the other, but each by a different judge.

In both cases, the government's motion to dismiss the research credit tax cases was two-pronged. First, the government moved to dismiss the case based on an assertion that the taxpayer's administrative claim filed with the IRS lacked specificity. In other words, the government argued that the IRS could not understand why the taxpayer wanted a tax refund. Second, the government moved to dismiss for failure to state a claim.

## 1. Lack of Specificity

In *Premier Tech*, the taxpayer filed an amended tax return that included Form 6765, "Credit for Increasing Research Activities." Form 6765 is the IRS form that a taxpayer must attach to an original return to disclose its calculation of research tax credits. The taxpayer assumed that attachment of Form 6765 to its amended return would suffice to disclose the nature of the claim. The taxpayer's Explanation of Changes section of the amended tax return stated that the claim was for research credits and that Form 6765 provided the amounts of qualified research expenses and the calculations of the refund amount. The government asserted that the refund claim – apparently referring to the Explanation of Changes – lacked specificity because it did not spell out every single element of qualification and quantification for the research credit. That level of excruciating detail is not required. The *Premier Tech* court rejected that argument, holding that the amended return and Form 6765 put the IRS on notice about the nature of the claim and that the IRS could not now say that its own forms were insufficient to constitute refund claims.

In *Intermountain Electric*, the IRS selected the research credit refund claim for examination and examined it over a period of five years before denying it. The taxpayer filed a complaint in federal court alleging that the IRS erroneously disallowed the claim. The government again argued that it had no notice of the taxpayer's claim because the amended return and Form 6765 lacked the requisite factual specificity even though the taxpayer completed the forms as required. The court finessed the issue, stating the taxpayer's responses to the IRS's information document requests during the five-year audit showed that the IRS considered the taxpayer's refund claim. The consideration constituted waiver by the IRS of any defect in the filing of the claim.

## 2. Failure to State a Claim

Having lost its motions in both cases to deny federal court subject-matter jurisdiction, the government then moved the federal court in both cases to dismiss the taxpayers' complaints for failure to state a claim. To defeat this motion, a taxpayer must allege sufficient facts in its complaint to state a claim for relief that is plausible on its face. In *Premier Tech*, the taxpayer's complaint did not allege the specific facts constituting qualification and quantification of the research credits, instead referring numerous times to the amended return and Form 6765. The court found that the references were sufficient to defeat the government's motion.

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The *Intermountain Electric* court reached a different conclusion. The taxpayer's complaint alleged, for example, that the taxpayer conducted a "process of experimentation," which is one of the statutory tests that a taxpayer must pass to claim research credits. The taxpayer did not, however, allege facts describing the experimental process in which the taxpayer engaged. The court found that the taxpayer had alleged only statutory labels and conclusions, but no facts. The court dismissed the complaint without prejudice, which provided the taxpayer with an opportunity to replead with sufficient facts showing that the taxpayer engaged in credit-worthy activities.

### 3. Lessons Learned

At a minimum, a taxpayer who, after filing an original return, now claims additional research tax credits should file a formal amended return including Form 6765 completed in all respects. However, the level of detail is a Morton's Fork, as both have a risk of unpleasant result.

A taxpayer filing a refund claim typically wants the IRS Service Center receiving the claim to survey the claim and allow it without sending it to field agents for full examination. This desire might be more aspirational if the IRS does not have long audit experience on the particular research activity, or if the explanation of changes in the amended return suggests to the IRS that the taxpayer lacks supporting documentation with the excruciating detail that the IRS might demand. However, if the IRS disallows the claim and the taxpayer litigates the disallowance, the Justice Department, which represents the United States in tax refund litigation, surely will seek to dismiss the litigation based on lack of specificity and failure to state a claim. The *Premier Tech* decision provides authority for the adequacy and specificity of the refund claim. However, *Premier Tech* is solely a decision from one federal district court in one state, and therefore does not constitute binding authority in other districts. As a result, a taxpayer is not assured that the *Premier Tech* approach will work effectively everywhere.

The other alternative is to provide more detail in the amended return. The risk here is that a more detailed explanation of the research might heighten the risk that the refund claim will be selected for examination.

### 4. Need for Better Legislative Guidance

One wonders if the government has succumbed to a fortress mentality regarding research credits. The IRS publishes a list of "Dirty Dozen Tax Scams." (News Release 2021-144, 07/1/2021). The IRS stated that the scams on the list are "generally marketed by unscrupulous promoters who make false claims about their legitimacy" and are "new ways to cheat the system." The research credit is on the IRS's dirty dozen list. It does not belong on the list. The credit is one of the most difficult tax provisions to administer, not only for the government but also for taxpayers. Frustrations exist on both sides. The IRS has made some effort to ease the administrative burden, like permitting reliance to some extent on financial statement research expenses as evidence of entitlement to the tax credit. Nonetheless, Congress must do a better job of devising a research credit that broadly incentivizes the performance of research and does not serve as fertile ground for disputes and litigation. Although bills are pending in Congress to increase the amount of the credit and even to require the IRS and Small Business Administration to educate small businesses about the availability of the credit, no pending bill addresses the disputes and current flurry of research credit litigation.

Please contact the authors to discuss how these rulings could impact your business.