

## IRS Announces Updates to Income Tax Credits for Research Expenditures

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The IRS Large Business and International Division ("LB&I") announced a campaign on February 27, 2020, to examine taxpayers' returns claiming income tax credits and deductions for research expenditures under IRC Sections 41 and 174, respectively. LB&I advises that examination of these credits and deductions has historically utilized significant examination resources, and that going forward, it intends to use issue-based examinations, updated forms and requests for guidance to promote voluntary compliance, to focus resources on the highest-risk research issues and to achieve examination consistency.

In an examination of research credits and deductions, LB&I often focuses on documentation of research activities in which the taxpayer engaged. Documentation that precisely conforms to LB&I's expectations is often problematic because a taxpayer's scientific and engineering departments typically do not maintain records of experiments as do academic researchers. If the taxpayer lacks documentation, LB&I oftentimes disallows the credits without disputing whether research was truly "qualified research" within the meaning of the tax law. To avoid this pitfall, burdensome as it may be, taxpayers should precisely document their compliance with each step set forth in the income tax regulations defining the process of experimentation.

The nature of required documentation to support claiming research credit has had a long and inconsistent history. Formerly, a number of different standards have been applied. Over a number of years, the Department of Treasury ("Treasury") initially proposed that a taxpayer document its research activities "appropriate for the particular field of science in which the experiment is conducted and for the type of experimentation involved." It then proposed that a taxpayer document its research activities "contemporaneously" with the results of experiments. The next iteration of the documentation requirement was preparation and retention of "written documentation before or during the early stages of the research project that describes the principal questions to be answered." The current standard, which is the standard that applies generally to substantiation of an item in a tax return, is that a taxpayer must retain "records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." As evident from Treasury's vacillation of documentation for research activities, LB&I's campaign objective to update forms has to be carefully monitored to ensure that the updated forms do not require information that is monumentally difficult to maintain and produce on audit.

Apart from documentation, LB&I should accept what now is an undisputed fact that credit-worthy qualified research should not be measured against academic research. Qualified research is intended to develop and improve consumer and industry products and production systems that produce such products. The income tax regulations expressly provide that a search for new scientific information is not required for expenditures to be eligible for the deduction and credit for research activities; this understanding should be in the forefront of LB&I's campaign.

The statutory provision for the research credit, essentially in its current form, was enacted as part of the Tax Reform Act of 1986. The deduction for research expenditures was adopted as part of the Internal Revenue Code of 1954. Apparently, having 34 years to examine the credit and 66 years to examine the deduction have not sufficed to achieve voluntary compliance by taxpayers and consistency of examinations by the Internal Revenue Service. Perhaps the campaign will achieve these objectives.

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Miller Canfield's tax team is experienced in conducting research credit studies, preparing claims for research credits on amended or original returns and defending such credits during IRS Exam and Appeals as well as in U.S. Tax Court.

Should you have any questions regarding LB&I's campaign outlined herein or the research credit in general, please contact the authors or your Miller Canfield attorney.