

**IRS’s “compliance campaigns”
that shift examination away
from entities toward issues
of significant risk non-compliance
may focus more attention on
R&D tax credits claims**

Use, but Don’t Abuse Those R&D Tax Credits

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any businesses perform some type of research and development (R&D)—the lifeblood of a growing and prosperous economy. A primary example is the entertainment industry in which many companies have over the years partly become technology companies. A telltale sign of such growth in R&D is the number of companies taking advantage of these federal tax credits under Internal Revenue Code Section 41. This can be seen, for example, in the public Securities and Exchange Commission filings of major entertainment companies.¹ However, many smaller businesses may not realize that some of their activities also may qualify for R&D tax credits.²

Section 41 was enacted as part of the Economic Recovery Tax Act of 1981.³ Originally known as

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the Research and Experimentation credit, the purpose of Section 41 was to improve the U.S. economy by reversing the decline in research spending. Tax credits were expected to help fund research and development and thus encourage technical design and product development, enhancement, and innovation.⁴

Businesses considering R&D tax credits soon learn, however, that potential benefits come at a price: learning to navigate Section 41's abundant, changing requirements and

regardless of the industry, to perform qualified activities as defined by Section 41(d), there are no limitations on the amount of expenses and, thus, tax credits, that can be claimed each year. If the R&D tax credit cannot be used immediately or completely, then any unused credit can be carried back one year or carried forward for up to 20 years.

Moreover, eligible businesses may apply for up to \$250,000 of R&D tax credits per year against payroll taxes.⁵ Section

products, processes, or inventions that meet certain requirements. Under Section 41, the term "qualified research" means research with respect to which expenditures may be treated as expenses under IRC Section 174.⁹ Treasury Regulation Section 1.174-2 delineates such expenses in the following manner:

Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product.¹⁰

In other words, the research does not have to result in success. Increased knowledge in a new process, which may evidence what not to do to successfully create a new product, can be a qualified expenditure, if technological in nature.

Treasury Regulation Section 1.174-2(a)(6) disallows Section 174 treatment for certain activities,¹¹ including: 1) ordinary testing or inspection of materials or products for quality control testing; 2) efficiency surveys; 3) management studies; 4) consumer surveys; 5) advertising or promotions; 6) acquisition of another's patent, model, production, or process; or 7) research in connection with literary, historical, or similar projects.

A taxpayer's quest for an R&D tax credit does not end here. Once a business determines that the expenses qualify under Section 174 and are not disqualified under Treasury Regulation Section 1.174-2(a)(6), the expenses must also satisfy a four-part test found in Section 41(d) as well as ensure that the activity is not subject to additional exceptions set forth in Section 41(d)(4).¹² The Section 41 four-part test has the following requirements:¹³

- Permitted Purpose ("Business Component Test"),¹⁴ i.e., substantially all of the activity or project must relate to the creation of new (or improvement to existing) functionality, performance, reliability, or quality of a business component.
- Elimination of Uncertainty ("Discovery Technology Information Test"),¹⁵ i.e., the activity must be intended to discover information that would eliminate uncertainty concerning the capability or method of developing or improving a product or process, or the appropriateness of the business component's design.¹⁶

THE IRS is concerned that many taxpayer claims involving R&D tax credits are being filed incorrectly, and because of the lack of specificity involved in such claims, it is difficult as well as time-consuming for the IRS to determine which claims are proper and which are not.

challenges. Congress wanted to encourage research through the tax laws without allowing taxpayers to abuse the credit, and in a process reminiscent of a slow-moving whack-a-mole, the rules change and often become more complex to rein in abuse. The result is a four-step process whereby the taxpayer must meet a test, not fall into a list of exemptions, meet another test, and not fall into yet another list of exemptions. Faced with what may feel like a moving, obscure target, businesses must ask themselves whether it is economically worthwhile for them to step into the swirling waters surrounding the pursuit of such tax credits. As with many provisions in the IRC, the answer (devil) is more often than not found in the details.

It is just as important that the Internal Revenue Service has begun to focus on potential abuse of the R&D tax credit. When the IRS starts focusing on abuse, taxpayers and their tax advisors need to be prepared even when they are merely taking advantage of a tax benefit to which they are entitled.

In simple terms, 6 to 8 percent of a business's qualifying R&D expenses can be claimed as a tax credit, in a dollar-for-dollar tax savings, to directly reduce its federal income tax liability. Section 41(a) sets out a formula for calculating the tax credit, which involves taking 20 percent of qualified research expenses over a base amount, then adding 20 percent of basic research payments and 20 percent of trade and business expenses. Since Congress intended that the R&D tax credits would be a financial incentive for businesses,

41(b)(2) defines in-house research expenses as any wages paid or incurred to an employee for qualified services performed by such employee, amounts paid or incurred for supplies used in the conduct of qualified research, and, under regulations prescribed by the Treasury Secretary, any amounts paid or incurred for the right to use computers in the conduct of qualified research.⁶ New businesses can annually offset up to \$250,000 federal payroll taxes for up to five years, with a maximum of \$1.25 million in total credits against quarterly tax returns.⁷

Evolution of R&D Tax Credits

Since its enactment in 1981, Section 41, which was initially provisional, has expired eight times and was extended 15 times. It was not until 2015, under the Protecting Americans From Tax Hikes Act of 2015 (PATH), that Section 41 was made permanent. Further incentives for businesses arose in 2017 under the Tax Cuts and Jobs Act of 2017 (TCJA), as a result of the repeal of the corporate alternative minimum tax (AMT) along with the reduction of the corporate tax rate from 35 to 21 percent.⁸ In 2021, expectations were that the Build Back Better (BBB) bill would further expand and increase in amount the eligible expenses for claiming R&D tax credits but, as of this writing, the BBB has not passed.

To qualify for R&D tax credits under Section 41, a business must be engaged in qualified research. In simple terms, qualified research is the expense incurred in activities involved in developing new

MCLE TEST NO. 305

The Los Angeles County Bar Association certifies that this activity has been approved for Minimum Continuing Legal Education credit by the State Bar of California in the amount of 1 hour. You may take tests from back issues online at <http://www.lacba.org/mcleselftests>. Answer sheets are not digitally fillable—they must be mailed with payment for hand grading. You will receive correct answers and a certificate by mail or e-mail when your test has been processed.

1. Expenses for research and development under 26 USC Section 41 are deducted from the income earned rather than directly reducing the income tax liability.
True.
False.
2. What percentage of qualified research expenses over a base amount of basic research payments and of trade and business expenses is to be added to determine the research credit under 26 USC Section 41 (a)?
 - a. 20 percent.
 - b. 40 percent.
 - c. 60 percent.
3. The amount of expenses that can be claimed as tax credits is capped at \$250,000.
True.
False.
4. All R&D tax credits must be used in the year the expenses occurred; unused credit expires.
True.
False.
5. Eligible businesses can offset up to \$250,000 of wages and other in-house research expenses per year for up to five years and a maximum of \$1.25 million.
True.
False.
6. While the R&D tax credit has existed since 1981, it has been permanent only since the Tax Cut and Jobs Act of 2017.
True.
False.
7. Development expenses for which of the following items may generally qualify for the R&D tax credit?
 - a. Processes.
 - b. Products.
 - c. Invention.
 - d. All of the above.
8. Research resulting in knowledge of what not to do to create a new product can qualify as expenditures, if it is technological in nature.
True.
False.
9. Treasury Regulation Section 1.174-2(a)(6) disallows Internal Revenue Code Section 174 treatment for which of the following activities.
 - a. Consumer surveys.
 - b. Laboratory Research.
 - c. Computer Science.
 - d. All of the above.
10. The acquisition of another's patent, model, or production does not qualify for an R&D tax credit.
True.
False.
11. 26 USC Section 41(d) requires that in order to qualify for the R&D tax credit, an activity must meet the following test(s):
 - a. Business Component Test.
 - b. Discovery Technology Information Test.
 - c. Process of Experimentation Test.
 - d. Section 174 Test.
 - e. All of the above.
12. Research relying on social science cannot qualify for R&D tax credit.
True.
False.
13. To determine whether or not expenses qualify for the R&D tax credit, it is irrelevant whether the research was conducted before or after the beginning of commercial production of the business component.
True.
False.
14. Which of the following regulations did not change for tax years starting after December 31, 2021?
 - a. Definition of qualified research as expenditures.
 - b. Capitalization or amortization period.
 - c. Ability to elect a reduced R&D tax credit.
 - d. Ability to elect to capitalize R&D expenses and amortize the cost over a 10-year period.
15. The R&D tax credits are on the compliance issue list of IRS's Large Business and International Division as well as IRS's 2021 "Dirty Dozen" list.
True.
False.
16. The promotion of inappropriate use of R&D tax credits is a serious concern of the IRS.
True.
False.
17. Chief Counsel Memorandum IR-2021-203 notes that R&D refund claims are currently examined in a substantial number.
True.
False.
18. The IRC requires filing R&D tax refund claims using Form 6765 and providing contemporaneous documentation, including all business components that form the factual basis of the R&D tax credit, all research activities performed by business component, and more.
True.
False.
19. IRS's Large Business and International Division's use of a compliance issue list to focus examination on certain issues, including R&D tax credits, will give rise to substantial litigation.
True.
False.
20. The cases *In re: Long-Distance Telephone Service Federal Excise Tax Litigation – MDL 1798, et al.*, and, recently, *Mann Construction v. United States* successfully argued IRS's violation of the Administration Procedures Act (APA).
True.
False.

MCLE ANSWER SHEET #305

USE, BUT DON'T ABUSE, THOSE R&D TAX CREDITS

Name _____

Law Firm/Organization _____

Address _____

City _____

State/Zip _____

E-mail _____

Phone _____

State Bar # _____

INSTRUCTIONS FOR OBTAINING MCLE CREDITS

1. Study the MCLE article in this issue.
 2. Answer the test questions opposite by marking the appropriate boxes below. Each question has only one answer. Photocopies of this answer sheet may be submitted; however, this form should not be enlarged or reduced.
 3. Mail the answer sheet and the \$25 testing fee (\$35 for non-LACBA members) to:

Los Angeles County Bar Association
Attn: Los Angeles Lawyer Test
P.O. Box 55020
Los Angeles, CA 90055
- Make checks payable to: Los Angeles County Bar Association.
4. Within six weeks, *Los Angeles Lawyer* will return your test with the correct answers, a rationale for the correct answers, and a certificate verifying the MCLE credit you earned through this self-study activity.
 5. For future reference, please retain the MCLE test materials returned to you.

ANSWERS

Mark your answers to the test by checking the appropriate boxes below. Each question has only one answer.

1. True False
2. A B C
3. True False
4. True False
5. True False
6. True False
7. A B C D
8. True False
9. A B C D
10. True False
11. A B C D E
12. True False
13. True False
14. A B C D
15. True False
16. True False
17. True False
18. True False
19. True False
20. True False

- **Qualified Purpose** (“Process of Experimentation Test”),¹⁷ i.e., the activity must constitute a systematic process designed to evaluate one or more alternatives to achieve a result in which the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer’s research activities, e.g., systematic trial and error, testing, modeling, and refining hypotheses.

- **Expenses are Technological in Nature** (“Section 174 Test”),¹⁸ i.e., the activity must fundamentally rely on principles of the physical or biological sciences, engineering, or computer science.

Treasury Regulations provide additional information regarding what activities fall, or do not fall, within each of the above tests. For example, Treasury Regulation Section 1.41-4(a)(4), which addresses the discovery test that requires the research must be technological in nature and must discover new information, provides that developing software products that are new and innovative compared with other commercially available software products in the field does not mean discovery of new information, nor does the mere evidence that the taxpayer has developed a new and useful product in and of itself qualify as discovering new information.

Irrespective of the business activity meeting the four-part test, under Section 41(d) (4), the following activities are excluded qualified research expenses: 1) research after commercial production;¹⁹ 2) adaptation of existing business components;²⁰ 3) duplication of existing business components;²¹ and 4) surveys, studies, etc.²²

For tax years starting after December 31, 2021, there are some key differences for determining the taxpayer’s qualification for, as well as calculating the amount of, the R&D tax credits, including:

- **Section 41(d)**, which for years prior to January 1, 2022, defined qualified research as expenditures that may be treated as expenses under Section 174, now reads “specified research or experimental expenditures under section 174, which are undertaken for the purpose of discovering information that is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation.”

- **IRC Section 280C(c)(1)**, which for years prior to January 1, 2022, required taxpayers to reduce their Section 174 deductions by the amount of Section 41 research

credit claimed for the tax period thus preventing a double benefit related to the R&D credit (i.e., expense & credit), and now reads “if the amount of the credit determined for the taxable year under section 41(a)(1) exceeds the amount allowable as a deduction for such taxable year for qualified research expenses or basic research expenses, the amount chargeable to capital account for the taxable year for such expenses shall be reduced by the amount of such excess.”

- **Section 280C(c)(2)**, which for years prior to January 1, 2022, provided taxpayers with the ability to elect a reduced R&D credit in lieu of adding back the Section 174 research expenses as promulgated under Section 280C(c)(1). The reduced credit is gross credit less the product of the gross Section 41 credit and the maximum rate of tax pursuant to Section 11(b) (i.e. 21 percent),²³ now reads “taxpayers are provided the ability to elect a reduced R&D credit in lieu of adding back the Section 174 research expenses as promulgated under Sec. 280C(c)(1).”²⁴

- **Section 174 expenses**, which for years prior to January 1, 2022, were either deducted in the current year or capitalized and amortized over a useful life of at least 60 months or for 10 years, for tax years after December 21, 2021, must be capitalized and amortized ratably over a five-year period, if conducted within the United States, or a 15-year period, if conducted outside the United States.

In contrast, other R&D incentives have not changed. For example, pursuant to Section 59(e), businesses could elect to capitalize all or a portion of R&D expenses and amortize the cost over a 10-year period. The TCJA did not repeal this code section; as such, businesses are still permitted to make this election, which would increase taxable income, allowing for net operating losses to be carried forward and, if applicable, allow the business to use the election to utilize available foreign tax credits.

Increased IRS Scrutiny

In January 2017, the IRS announced a new audit strategy for its Large Business and International (LB&I) Division known as “compliance campaigns.”²⁵ An IRS compliance campaign involves shifting examination resources away from entities and toward issues that the LB&I has determined present a significant risk of non-compliance. The campaign approach is intended to improve return selection for examination risk, while also addressing resource challenges facing the IRS.

Initially, the IRS selected 13 compli-

ance issues. Over the past five years, the LB&I has added additional campaigns and removed some. At last count, the IRS has selected 55 compliance issues.²⁶ Among the current compliance campaigns, added on February 27, 2020, is “Research Issues,” which directly involves Sections 41 and 174.

In addition to IRS compliance campaigns, the IRS has its annual “Dirty Dozen” list.²⁷ This is a list intended to provide taxpayers a heads-up so as not to fall prey to a variety of common scams that taxpayers may encounter anytime but that may peak during filing season.²⁸ While R&D tax credits are on the IRS’s 2021 “Dirty Dozen” scams list,²⁹ and there may be abuses in the area, the R&D tax credit arguably should not be on this list.

Under the heading of “Improper claims of business credits” the list states:

Improper claims for the research and experimentation credit generally involve failures to participate in, or substantiate, qualified research activities and/or satisfy the requirements related to qualified research expenses. To claim a research credit, taxpayers must evaluate and appropriately document their research activities over a period of time to establish the amount of qualified research expenses paid for each qualified research activity. Taxpayers should carefully review reports or studies to ensure they accurately reflect the taxpayer’s activities.

An increase in the number of businesses that are claiming R&D tax credits or even an individual business’s increase in the amount of claimed R&D tax credits based upon the above-noted changes in the tax laws, which have encouraged both forms of legitimate behavior, is not an appropriate reason for including this tax benefit in the Dirty Dozen list. Rather, the problem is that there are “promoters” who are improperly marketing, i.e., promoting, R&D tax credits to businesses that do not actually qualify for such tax credits and who may also be charging a significant fee, or percentage of the ultimate tax credits, in return for marketing excessive and improper credits.

In cases involving abusive promoters, in addition to LB&I campaigns, the Dirty Dozen list, and routine everyday audits, such abusive tax schemes are also in the crosshairs of the IRS’s new Office of Promoter Investigations (OPI). Established in April 2021, OPI is led by Lois Deitrich, a 20-year veteran of the agency, and its mission is to increase focus on promoters

FLOW CHART OF WORK PAPER 401 HURDLES

Work Paper			
402-1.3	Hurdle #1: Do business components meet the legal definition?	- No (Fail) →	Disallow all research expenses tied to research activities that do not pass ALL Hurdles #1-8.
	↓ Yes (Pass)		
402-1.3	Hurdle #2: Are business components "new and improved"?	- No (Fail) →	
	↓ Yes (Pass)		
402-1.11	Hurdle #3: Does identified Uncertainty meet the legal definition?	- No (Fail) →	
	↓ Yes (Pass)		
402-1.18	Hurdle #4: Are identified alternatives intended to eliminate Uncertainty?	- No (Fail) →	
	↓ Yes (Pass)		
402-1.18	Hurdle #5: Is there a process of evaluating the tested alternatives ?	- No (Fail) →	
	↓ Yes (Pass)		
	Hurdle #6: Do research activities "involve a methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis, and retest the hypothesis so that it constitutes experimentation in the scientific sense"?	- No (Fail) →	
	↓ Yes (Pass)		
402-1.23	Hurdle #7: Is the information discovered technological in nature?	- No (Fail) →	If ANY of Hurdles #1-8 fail, the research expenses do not qualify for the IRC § 41 research credit.
	↓ Yes (Pass)		
402-1.25	Hurdle #8: Are there adaptations of business components (exclusion)?	- Yes (Fail) →	Only research expenses tied to research activities that pass ALL of Hurdles #1-8 can be considered for Hurdle #9.
	↓ No (Pass)		
402-1.27	Hurdle #9: Does law allow estimating of employee qualified research percentages?	- No (Fail) →	Disallow qualified wage expenses
	↓ Yes (Pass)		
402-1.27	Hurdle #10: Is there a valid basis for estimating research credit amount?	- No (Fail) →	Disallow qualified research expenses
	↓ Yes (Pass)		
402-1.28	Hurdle #11: Is research credit amount computed correctly?	--- No --- →	Disallow incorrect credit amount
	↓ Yes (Pass)		
402-1.28	Hurdle #12: Is research credit amount allocated correctly?	--- No --- →	Disallow credit amount
	↓ Yes (Pass)		
	Allow correct research credit amount		

of abusive tax avoidance transaction.³⁰

In the face of such increased IRS scrutiny, businesses claiming R&D tax credits should be prepared for a more focused examination, including requests for the production of detailed records and documentation as part of any IRS inquiry. For example, businesses claiming R&D tax credits should ensure they maintain records that substantiate the amounts claimed, provide evidence of the nexus between the amount expended and the innovative activities being performed, and which support the qualified nature of the activities. (Above is an example of a flow chart IRS examiners may be expected to use in auditing R&D tax credits.)

The IRS is also concerned that promoters are encouraging improper claims for refund concerning these credits. As such, the sufficiency or insufficiency of refund claims involving R&D tax credits has recently become a very significant issue for the IRS.

When it comes to the intricacies of filing a proper claim for a refund of federal taxes, taxpayers are, and have been for decades, subject to IRC Section 7422, along with IRC Section 6402 and the regulations promulgated thereunder, which set forth the rules regarding claims for refund, including the specificity of the basis for the claim for refund as well as the calculation of the amount claimed, when the claim may be filed, what forms may be

used, the location for filing, and signature requirements. A recent decision from the District of Maryland provides a robust example of the many technical requirements and opportunities for missteps along the way to obtaining a refund claim, valid or otherwise.³¹ The court in that case addressed in depth Treasury Regulation Section 301.6402-2(b)(1)'s requirement that "[t]he 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." This requirement is necessary to prevent surprise and give the IRS adequate notice of the claim and its underlying facts so that it can make an administrative investigation and determination regarding the claim.

On October 15, 2021, the IRS released a Chief Counsel Memorandum (CCM), IR-2021-203, providing examiners, and taxpayers, with the information that taxpayers will be required to include for a valid Section 41 refund claim.³² The IRS release specifically noted that the CCM "will be used to improve tax administration with clearer instructions for eligible taxpayers to claim the credit while reducing the number of disputes over such claims." The IRS is concerned that many taxpayer claims involving R&D tax credits are being filed incorrectly, and because of the lack of specificity involved in such claims, it is difficult as well as time-consuming for the IRS to determine which claims are proper

and which are not. The CCM, noting further that "[c]laims for research credit under IRC Section 41 are currently examined in a substantial number of cases and consume significant resources for both the IRS and taxpayers," also suggests that examiners reject any claim that does not maintain all of the information above before initiating an audit (or otherwise actively considering the refund claim on the merits) to eliminate the likelihood that a court will find that the IRS waived the specificity requirement for a valid refund claim. The specificity requirement is a prerequisite to filing a court case to seek a refund, so the IRS's reference to reducing the number of disputes reaches beyond merely reducing the number of administrative disputes to also reducing the number of successful research credit refund cases.

Following on the heels of that announcement, on January 3, 2022, the IRS issued "Interim Guidance and Frequently Asked Questions" (FAQs) that establish procedures for the IRS to determine the legal sufficiency of a research credit refund claim.³³ In addition to a written declaration under penalties of perjury required of all refund claims—in this case, for research credit refund claims—the IRS recommends that taxpayers use Form 6765, Credit for Increasing Research Activities, and that they also provide, at minimum, the following five pieces of contemporaneous documentation: 1) all busi-

ness components that form the factual basis of the R&D tax credit claim for the claim year; 2) all research activities performed by business component; 3) all individuals who performed each research activity by business component; 4) all the information each individual sought to discover by business component; and 5) the total qualified expenses of employee wage expenses, supply expenses, and contract research expenses.³⁴

The criticism of tax practitioners to these new filing requirements has been significant,³⁵ and the IRS's use of a CCM and FAQs, in lieu of promulgating regulations with the appropriate Administrative Procedures Act (APA) safeguards, can be expected to result in future litigation, similar to what was seen in *In re Long-Distance Telephone Service Federal Excise Tax Litigation – MDL 1798, et al.*³⁶ or, more recently, *Mann Construction v. United States* (holding that the IRS violated the APA by failing to subject a tax shelter listing notice to “notice and comment.”)³⁷ Nevertheless, businesses that are filing R&D tax credit refund claims should follow best practices, including using the Form 6765 credit for increasing research activities, and include with specificity all information requested under the five specified categories set forth above and do so for each business component that is the subject of the claim for refund under Section 41.

With the expiration of a grace period (which ended January 10, 2022), businesses are now in the midst of a one-year transition period during which taxpayers will have 45 days to perfect a research credit claim for refund prior to the IRS's final determination on the claim.³⁸

Congressionally enacted statutes that are intended to support businesses, encourage business innovation, and, ultimately, create good jobs in the United States by way of tax credits and financial and other incentives are far from a new idea. To the contrary, such tax incentives are replete in the IRC. Equally prevalent are the challenges faced not only by the IRS but also by taxpayers in ensuring that businesses are educated in the appropriate ways to qualify and avail themselves of such tax benefits as Congress intended.

As with all things involving income, expenses, and deductions, in the case of businesses claiming R&D tax credits, documenting and calculating qualified research activities is critical. Essentially, businesses need to have their paperwork in order. While increased IRS scrutiny of R&D tax credits is one motivation for good recordkeeping, proper recordkeeping

also means protecting a business's right to claim such credits to the maximum rather than leaving money on the table. ■

¹ See, e.g., AT&T merger with Time Warner Media, Form 10-K, available at <https://www.sec.gov/Archives/edgar/data/1105705/000119312518053619/d504160d10k.htm>; Activision Blizzard Form 10-K, available at <https://www.sec.gov/ix?doc=/Archives/edgar/data/718877/000162828022003992/atvi-20211231.htm>; Spotify Technology S.A. Form 20-F, available at https://www.sec.gov/Archives/edgar/data/1639920/000156459020004357/ck0001639920-20f_20191231.htm; Netflix, Inc. Form 10—K, available at <https://www.sec.gov/Archives/edgar/data/1065280/00010652801800069/q4nflx201710k.htm>; Apple Inc. Form 10-K, available at <https://www.sec.gov/Archives/edgar/data/320193/000119312513416534/d590790d10k.htm>.

² While this article focuses primarily on federal R&D credits, it is noted that California—as well as other states—have similar provisions. E.g., REV. & TAX. CODE §23609, 17052.12.

³ 26 U.S.C. §41.

⁴ S. 1203, 111th Cong. (2009), available at <https://www.govinfo.gov/content/pkg/BILLS-111s1203is/pdf/BILLS-111s1203is.pdf>.

⁵ A qualified small business or start-up company may elect to apply up to \$250,000 of its research credit computed under Section 41 against the employer portion of its Federal Insurance Contributions Act payroll tax liability imposed under IRC Section 3111(a) for up to each of five tax years, to maximum of \$1.25 million. I.R.C. §41(d). To be eligible, the business must have gross receipts of less than \$5 million for the credit tax year and have no gross receipts for any taxable year dating back more than five years ending with the current taxable year.

⁶ For contract research expenses, the allowable amount is 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research. I.R.C. §41(b)(3).

⁷ IRS, Qualified Small Business Payroll Tax Credit for Increasing Research Activities, <https://www.irs.gov/businesses/small-businesses-self-employed/qualified-small-business-payroll-tax-credit-for-increasing-research-activities> (last accessed Apr. 21, 2022).

⁸ Under the PATH Act, only eligible small businesses may use the R&D credit to offset AMT. Section 38(c)(5) of the IRC defines an eligible small business as a non-publicly traded corporation, a sole proprietorship, or a partnership with average annual gross receipts over the prior three years of \$50 million or less. Under TCJA, not only did eligible small businesses retain this tax benefit, but with the repeal of the AMT for corporation, additional businesses obtained the benefit for tax years beginning after December 31, 2017.

⁹ I.R.C. §41(d)(1)(A).

¹⁰ 26 C.F.R. §1.174-2.

¹¹ *Id.*

¹² See “[Section] 41(d)(4) Activities for Which Credit not Allowed.” at https://www.irs.gov/pub/irs-regis/research_credit_basic_sec41.pdf.

¹³ IRS, Audit Techniques guide, <https://www.irs.gov/businesses/audit-techniques-guide-credit-for-increasing-research-activities-i-e-research-tax-credit-irc-41-qualified-research-activities> (last reviewed or updated Oct. 28, 2021).

¹⁴ I.R.C. §41(d)(2)(B) (“The term ‘business component’ means any product, process, computer software, technique, formula, or invention which is to be—(i) held for sale, lease, or license, or (ii) used by the taxpayer in a trade or business of the taxpayer.”)

¹⁵ I.R.C. §41(d)(1)(B)(i).

¹⁶ Treas. Reg. §.174-2(a)(1).

¹⁷ I.R.C. §41(d)(1)(C).

¹⁸ 26 C.F.R. §1.41-4(a)(4).

¹⁹ I.R.C. §41(d)(4)(A) (any research conducted after the beginning of commercial production of the business component).

²⁰ I.R.C. §41(d)(4)(B) (any research related to the adaptation of an existing business component to a particular customer's requirement or need).

²¹ I.R.C. §41(d)(4)(C) (any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component).

²² I.R.C. §41(d)(4)(D)(i)-(v) (any of the following: 1) efficiency survey, activity relating to management function or technique; 2) market research, testing, or development (including advertising or promotions); 3) routine data collection; or 4) routine or ordinary testing or inspection for quality control).

²³ A valid I.R.C. §280C(c)(3) election, which is irrevocable and only applies to the tax year in which it is made, to take a reduced credit must be made on a timely filed return, including extensions.

²⁴ A valid IRS §280C(c)(2) election to take a reduced credit must be made on a timely filed return, including extensions.

²⁵ IRS, Large Business and International Compliance Campaigns, <https://www.irs.gov/businesses/large-business-and-international-compliance-campaigns> (last accessed Apr. 21, 2022).

²⁶ IRS, Large Business and International Active Campaigns, <https://www.irs.gov/businesses/corporations/lbi-active-campaigns> (last accessed Apr. 21, 2022).

²⁷ IRS, Dirty Dozen, <https://www.irs.gov/newsroom/dirty-dozen> (last accessed Apr. 21, 2022).

²⁸ *Id.*

²⁹ Press Release, IRS, IRS wraps up its 2021 “Dirty Dozen” scams list with warning about promoted abusive arrangements (IR-2021-144, July 1, 2021), available at <https://www.irs.gov/newsroom/irs-wraps-up-its-2021-dirty-dozen-scams-list-with-warning-about-promoted-abusive-arrangements>.

³⁰ Press Release, 20-year Exam veteran selected as new Office of Promoter Investigations acting director (IR-2021-88, Apr. 19, 2021), available at <https://www.irs.gov/newsroom/20-year-exam-veteran-selected-as-new-office-of-promoter-investigations-acting-director>.

³¹ *Oosterwijk v. United States*, No. 1:21-cv-01151-CCB, at 7 (D. Md. Jan. 27, 2022).

³² Memorandum from Kathryn A. Meyer, Area Counsel, to Cheryl Teifer, IRS Director, Field Operations Eng'g re I.R.C. §41 Research Credit Refund Claims (Sept. 17, 2021), available at <https://www.irs.gov/pub/irs-lafa/20214101f.pdf>.

³³ Press Release, IRS, IRS sets forth required information for a valid research credit claim for refund (IR-2021-203, Oct. 15, 2021), available at <https://www.irs.gov/newsroom/irs-sets-forth-required-information-for-a-valid-research-credit-claim-for-refund>.

³⁴ IRS, About Form 6765, Credit for Increasing Research Activities, <https://www.irs.gov/forms-pubs/about-form-6765> (last accessed Apr. 21, 2022).

³⁵ See taxnotes, Implementing the Research Credit Memo (Jan. 31, 2022), 607.

³⁶ *In re: Long-Distance Telephone Service Federal Excise Tax Litigation – MDL 1798, et al.*, 853 F. Supp. 2d 138, 142-43 (D. D.C. 2012).

³⁷ *Mann Constr. v. United States*, No. 21-500 (6th Cir. Mar. 3, 2022).

³⁸ IRS, Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions, <https://www.irs.gov/businesses/corporations/research-credit-claims-section-41-on-amended-returns-frequently-asked-questions> (last accessed Apr. 21, 2022).