



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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MEMORANDUM FOR LMSB AND SB/SE EXECUTIVES, MANAGERS
AND EXAMINERS

FROM:

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SUBJECT:

Section 41 Credit for Increasing Research Activities
("Research Credit"): Current Audit Inventory Guidelines and
Claim Processing

Introduction

This memorandum sets forth guidelines for the efficient use of audit time and resources currently devoted to research credit issues.

Background

On December 26, 2001, Treasury and the IRS published proposed regulations on the computation of the research credit under section 41(c), the definition of qualified research under section 41(d), and the exception to the internal-use software exclusion under section 41(d)(4)(E).

The proposed regulations, as they relate to the computation of the research credit under section 41(c), are proposed to be applicable for taxable years ending on or after December 26, 2001. The rules of the proposed regulations are consistent with the rules in T.D. 8930, on which taxpayers are already relying.

The proposed regulations, as they relate to the definition of qualified research under section 41(d), are also proposed to be applicable to taxable years ending on or after December 26, 2001. However, for all open taxable years, we will not challenge return positions consistent with the proposed regulations and taxpayers may rely on these proposed regulations until they are finalized. We are adopting this position notwithstanding the provisions of T.D. 8930, as well as recent court opinions that provide different criteria for research credit qualification. Authority for this position is stated in the attached "LMSB and SB/SE Commissioners' Administrative Guidance for

Research Credit Cases" issued on January 10, 2002 ("LMSB and SB/SE Administrative Research Credit Guidance").

Furthermore, the proposed regulations, as they relate to the internal-use software exclusion (including the rules relating to the exception for software satisfying the high threshold of innovation test) under section 41(d)(4)(E), are proposed to be applicable for taxable years beginning after December 31, 1985. However, we will not challenge return positions consistent with the rules in T.D. 8930, or alternatively with the proposed regulations, until the proposed regulations are finalized.

Current Audit Inventory Guidelines

In light of the above, consider the following where audit resources are currently allocated to research credit issues:

For ongoing audits where a Form 5701 or a Form 4549 has not yet been prepared, you should ensure that research credit issues are developed in accordance with the LMSB and SB/SE Administrative Research Credit Guidance.

For ongoing audits where a Form 5701 or a Form 4549 has been prepared, you should ensure that any proposed research credit adjustments are made in accordance with the LMSB and SB/SE Administrative Research Credit Guidance. If, for example, the taxpayer's failure to meet the "discovery test" as set forth in T.D. 8930 was a basis for the proposed adjustment, this basis should be withdrawn, and the facts developed on audit should be applied as set forth in the LMSB and SB/SE Administrative Research Credit Guidance to determine whether an alternative basis for adjustment is appropriate. If necessary and time is available, the examiner should consider additional factual development. If the facts as developed on audit (or subsequently) do not provide an alternative basis for adjustment, a proposed adjustment based solely upon the "discovery test" as set forth in T.D. 8930 should not be made.

Centralized Refund Claim Filing

The IRS is taking the following steps in order to understand the filing patterns that may result from the definitional changes and bring specialized expertise into the research credit claim classification process:

Notice 2002-44, to be published in the Internal Revenue Bulletin on July 8, 2002, applies to taxpayers required to file Form 1120 that wish to claim a credit or refund attributable to the research credit. Under Notice 2002-44, such claims for credit or refund must generally be filed with the Ogden Service Center, regardless of the Service Center where the original Form 1120 was filed.

Alternatively, if the taxpayer is presently under audit for the year in question, the taxpayer may, with the concurrence of the Team Manager (or SB/SE Manager), directly submit the claim for credit or refund to the Team Manager and mail a copy to Pre-Filing and Technical Guidance at LMSB Headquarters. (This procedure does not apply to other than 1120 amendments.)

In order to receive administrative consideration by LMSB or SB/SE, all claims for credit or refund subject to Notice 2002-44 filed with the Team Manager (or SB/SE Manager) must include a completed Form 6765 and must, among other things:

- (1) Set forth in detail each ground upon which a credit or refund is claimed;
- (2) Set forth facts sufficient to apprise the Service of the exact basis thereof; and
- (3) Be verified by a written declaration that it is made under the penalties of perjury.

Proc. and Admin. Reg. § 301.6402-2(b)(1). Accordingly, Team Managers (or SB/SE Managers) should return claims for credit or refund subject to Notice 2002-44 that do not comply with these requirements to the taxpayer for correction, notwithstanding that such a deficient claim might, in some instances, satisfy the jurisdictional prerequisite for filing a refund suit. The acceptance of the claim and examination of the claim should be delayed until such deficiencies are corrected.

Guidelines on Late Cycle Refund Claims

A common issue, and one that may increase in frequency in light of the proposed regulations, is the filing of refund claims late in the audit cycle. In such circumstances, you can make the decision to postpone auditing the refund claim until the current audit cycle is complete, complete the refund claim audit simultaneously with concluding the current audit cycle, or start the refund claim audit but not complete it before closing the current audit cycle. Customer service should always be a major factor in our decision-making process, but our ability to conduct an efficient and effective audit is also important.

Sampling Field Directive

On March 4, 2002, a Field Directive was issued on the use of both statistical and judgmental sampling techniques in research credit audits. The Field Directive also addresses frequently asked questions concerning the use of these techniques. This document may be accessed on the LMSB Intranet at:

http://lmsb.irs.gov/hq/fs/cas/downloads/ZIP/ss_directives_2002_03_04.zip

Any questions on the issues set forth in this memorandum should be referred to Lee Keenan, Research Credit Technical Advisor, at (508) 845-1704, or Dan Rosen, Research Credit Industry Counsel, at (212) 298-2060.

**LMSB and SB/SE COMMISSIONERS' ADMINISTRATIVE GUIDANCE FOR
RESEARCH CREDIT CASES**

The Treasury Department and the IRS issued proposed regulations on the computation of the research credit under section 41(c), the definition of qualified research under section 41(d), and the exception to the internal-use software exclusion under section 41(d)(4)(E).

Computation of the Research Credit under Section 41(c)

The proposed regulations, as they relate to the computation of the research credit under section 41(c), are proposed to be applicable for taxable years ending on or after December 26, 2001. The rules of the proposed regulations are consistent with the rules in TD 8930, on which taxpayers are already relying.

Definition of Qualified Research under Section 41(d)

The proposed regulations, as they relate to the definition of qualified research under section 41(d), are also proposed to be applicable to taxable years ending on or after December 26, 2001. However, for all open taxable years, we will not challenge return positions consistent with the proposed regulations and taxpayers may rely on these proposed regulations until they are finalized. We are adopting this position notwithstanding the provisions of TD 8930, as well as recent court opinions that provide different criteria for research credit qualification.

Exclusion for Internal-use Software

The proposed regulations, as they relate to the internal-use software exclusion (including the rules relating to the exception for software satisfying the high threshold of innovation test) under section 41(d)(4)(E), are proposed to be applicable for taxable years beginning after December 31, 1985. However, we will not challenge return positions consistent with the rules in TD 8930 or with these proposed regulations until the proposed regulations are finalized.