



The Evolving Landscape of Evidentiary Substantiation During R&D Tax Credit Audits

Jason D. Carr, Esq., LL.M.

This white paper discusses recent interpretations of sufficient evidentiary substantiation and lays out important factors to consider when proving up a claim during an IRS audit focused on a research credit.

Introduction

The term “evidentiary substantiation” describes the evidence or proof used by an organization to support its claimed tax credit. Once an R&D tax audit arises, the key question is whether the organization can prove that each qualified research activity (“QRA”), each qualified research expense (“QRE”), and the connection (i.e., the “nexus”) between the two, are sufficient under IRC § 41.

Unsurprisingly, the adequacy of evidentiary substantiation provided by organizations to support their QRAs and QREs is typically the most contentious aspect of R&D tax credit audits with the IRS (and states too, for that matter). This issue most often arises because the method used to prove up the research credit (i.e., the conduct of each QRA and the connected payments as valid QREs) conflicts with the normal accounting process used by organizations in their day-to-day operations. This issue, combined with the insufficient level of substantiation guidance provided by Congress or the IRS, has consequently led many organizations to unsuccessfully defend their claimed tax credits during audits.

IRS Interpretation

Although the IRS has issued limited guidance with respect to evidentiary substantiation, all organizations are uniformly held to the guidance under § 41 which reads, in part, that “[a] taxpayer claiming a credit under Section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.”ⁱ

The IRS addressed substantiation back in 2004 when it stated that organizations can record QRAs and QREs using a system appropriate to their accounting system and records so long as they could be audited.ⁱⁱ

The IRS further indicated that in general, project or cost center-based approaches that align with accounting systems are generally auditable, whereas so-called “hybrid-approaches” involving expenses captured on a cost center basis, typically involving a summation of W-2s attached to non-qualifying activities and based on after-the-fact management opinions, do not align with § 41 requirements.ⁱⁱⁱ

The IRS also released two audit technique guides that expanded on the 2004 report and solidified the IRS’s position that the only clear way to substantiate an R&D tax credit is to provide contemporaneous project-based records for each QRA, while also contemporaneously tracking each employee activity/time and expense incurred on each QRA. In particular, the IRS indicated that after-the-fact employee time allocations and narrative creation (including those supported by significant documentation), run the risk of being deemed insufficient during audit.

The IRS’s views discussed above are clearly the agency’s interpretation of § 41 with respect to evidentiary substantiation, and not the law itself. As discussed below, the IRC, regulations, and case law may be used to reasonably prove up an organization’s position that is contrary to the IRS’s positions discussed herein.

IRC and Regulatory Interpretation

Section 41 fails to directly address evidentiary substantiation requirements, but instead refers to record retention requirements in accordance with Section 6001, which in turn requires taxpayers to maintain records in compliance with the “rules and regulations” required by the Secretary of the Treasury. These regulations, in turn, require that organizations keep “permanent books of account or records ... as are sufficient to establish the amount of gross income, deductions, [or] credits.”^{iv} The records must be kept accurately “but no particular form is required for keeping the records.”^v And the records must be retained for “so long as the contents thereof may become material in the administration of any internal revenue law.”^{vi}

In other words, the IRC, and regulations themselves may not be exclusively relied upon, beyond these statements, with respect to evidentiary substantiation during R&D audits.

Judicial Interpretation

Although the regulations and IRS interpretation above focus primarily on substantiation via contemporaneous records, case law demonstrates that organizations can support their tax credit claim in other ways, and that each case is a facts and circumstances-based inquiry.

For example, in *Cohan*, the Tax Court found that while taxpayers have an obligation to keep records that can sufficiently detail QREs, the failure to keep records in a particular manner should not serve as a basis for denying an R&D credit.^{vii}

Likewise, the court in *Suder* held that QREs are not required to be accumulated on a project or business component basis, nor are specific types of documents required to substantiate them.^{viii} Further, *Suder*, along with *Fudim*, *McFerrin*, *Union Carbide*, established that if an organization can prove it engaged in QRAs, and provides reliable evidence to estimate QREs, a court is obligated to estimate such QREs rather than deny a claimed credit due to insufficient documentation.^{ix}

In *Union Carbide*, the court held that an organization may substantiate QREs and QRAs with credible fact and expert witness testimony, while the court in *Shumi* held that uncorroborated time allocations by an employee not involved in the QRAs or highly paid executives with no scientific background are insufficient to make an estimate.^x

Preparing Your Evidentiary Substantiation

As the aforementioned case law and IRS interpretation indicates, contemporaneous records play an important role in substantiating a research tax credit claim. Organizations with contemporaneous records of their QRAs and QREs are best positioned to obtain a favorable outcome during an audit. While no specific type of documentation is required, the type used will vary based on the facts and circumstances of the specific situation (e.g., industry, accounting, records, etc.). Sample document types may include:

SAMPLE QRA SUBSTANTIATION	SAMPLE QRE SUBSTANTIATION
<ul style="list-style-type: none">▪ Test plans and reports▪ Research memos and summaries▪ Project budgets and work orders▪ Lab & research notebooks▪ Test data and results▪ Papers, treatises, publications▪ Regulatory submissions▪ Job descriptions▪ Time logs and employee reviews	<ul style="list-style-type: none">▪ General ledgers▪ Payroll records▪ Invoices▪ Contracts▪ Time-keeping records▪ Analyses of accounts▪ Budgets▪ Tax calculations▪ Taxpayer-specific accounting records

All evidentiary substantiation should be collected and retained while considering the four qualified research tests of § 41(d)(1) to prove up QRAs. Organizations should also focus on documents generated in its day-to-day operations, as opposed to anything generated specifically for tax purposes. Likewise, organizations should attempt to leverage the researchers, managers, and personnel used on QRAs, and figure out the best way to memorialize their first-hand information to support documentation. Completing these activities in “real-time”, or as close as possible to the timeframe during which the QRAs are conducted is highly recommended, while waiting until an IRS audit or later is not.

Establishing Nexus with 3rd Party Studies

As discussed herein, the IRS expects organizations to provide evidentiary substantiation to establish a factual connection (i.e., the nexus) between claimed QRAs and the QREs paid or incurred during such activities.

The most common method for organizations to establish nexus is through a comprehensive study of the QRAs and QREs conducted by an independent 3rd party using a combination of surveys, interviews of pertinent individuals, relevant data, and contemporaneous documentation. The quality, depth, and detail of this type of study to support a research credit claim will determine its ability to withstand IRS scrutiny on audit, or alternatively, Tax Court scrutiny in litigation.

For example, interviewees should have first-hand knowledge of the research activities aligned with a specific cost center. Time and percentage allocations are generally best defended when they involve relevant personnel closely aligned with the specified research activity (e.g., a design engineer in a research department). Providing such allocations in significant detail and as close as possible as the time when the work is performed is recommended.

In summary, nexus is typically achieved where a credible employee with first-hand knowledge of QRAs and QREs describe in reasonable detail the nature of the activities and the percentage of time spent on such activities, and such descriptions are supported by contemporaneous records.

Organizations must also gather supporting information that illustrates the individual's role in the activities, and how they respectively impacted the progress of the QRA. Other best practices include, inter alia, the collection of documentation with the individual's name on it, such as emails, memos, meeting minutes, and calendars, while also considering the individual's technical background as it relates to the specific QRAs.

Statistical Sampling Methodologies and Estimates

As discussed above, the *Cohan* doctrine prevents the denial of a research tax credit in the absence of documentation to substantiate the precise amounts in QREs when an organization can prove QRAs occurred and provide a sufficient evidentiary basis to permit courts to estimate the QREs.

In instances where an organization's QRAs involve voluminous projects, personnel, or contracts, sampling should be used in establishing a basis for establishing or auditing each research claim. Accordingly, an organization should follow Rev. Proc. 2011-42 and consult with a statistician to produce the most accurate estimates available under the circumstances.

A Brief Note on 2022 Claims and Beyond

Chief Counsel Memorandum 20214101F ("CCM") significantly impacted R&D credit claims filed on January 10, 2022, or later in terms of tax return information requirements. With respect to evidentiary substantiation, the significance of this change means that taxpayers who fail to satisfy such requirements will result in an outright denial of the credit without audit. Accordingly, organizations must adjust their processes to comply with the CCM or be prepared to litigate in 2023 and beyond.

Such litigation will involve first, overcoming a Motion to Dismiss by establishing that a claim not meeting CCM requirements is valid, followed by an argument that establishes eligibility of the credit based on a facts and legal analysis. Although such litigation has not occurred at the time of this writing, a further evolution of evidentiary substantiation may occur as R&D credit cases arise before courts under this new paradigm.

Conclusion

The R&D Tax Credit has proven to be an invaluable, dollar-for-dollar tax savings mechanism for organizations that perform qualified research in the U.S. Over the several decades since the legislation was first written, case law and IRS guidance have clearly provided guidelines that may be used to successfully support claimed R&D credits. Accordingly, organization's that make the necessary investment to satisfy the evidentiary substantiation requirements discussed in this document, have a significantly better chance of a successful outcome in the event of audit than those that do not.

To learn more about how The Law Office of Jason Carr defends organizations nationwide during R&D tax credit audits, visit www.carrtaxlaw.com.

The Law Office of Jason Carr, PLLC
2626 Cole Avenue, Ste. 300
Dallas, TX 75204 USA
214.800.2366
hello@carrtaxlaw.com

ⁱ Code of Federal Regulations (CFR) 1.41-4 A.

ⁱⁱ IRS Briefing Paper on Cost Capturing, *supra* n.2.

ⁱⁱⁱ *Id.* at 6.

^{iv} IRC § 6001-1(a).

^v *Id.*

^{vi} IRC § 6001-1(a).

^{vii} *Cohan v. Commissioner*, 39 F.2d 540 (2nd Cir. 1930).

^{viii} *Suder v. Commissioner*, T.C. Memo 2014-201, 2014 WL 4970724.

^{ix} *Id.*; *Fudim v. Commissioner*, T.C. Memo 1994-234, 1994 WL 223280; *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Union Carbide Corp. v. Commissioner*, T.C. Memo 2009-50, 2009 WL 605161, *aff'd*, 697 F.3d 104 (2nd Cir. 2012).

^x *Shami v. Commissioner*, T.C. Memo 2012-78, 2012 WL 952850, *aff'd*, 741 F.3d 560 (5th Cir. 2014).