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September 15, 2015

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VIA E-MAIL (Kathryn.L.Gregg@irs.gov)

Re: Review of Selected Industry Research and Development Credit Examination Directives

Dear Ms. Gregg:

On behalf of Tax Executives Institute, thank you for the opportunity to join with other stakeholder organizations on August 6, 2015, to review and offer comments on five draft research credit directives being considered for joint release by LB&I and the Small Business and Self Employed Division.[1] Over many years, TEI and the IRS have developed a strong and constructive working relationship that has enabled us to exchange views on issues of common interest and offer insights and feedback on key elements of various IRS examination programs. TEI has been an active participant and contributor to IRS

[1] The draft directives consisted of research credit examination guidance in the following areas:

1. Machine Shops and Other Job Shops,
2. Food Industry Taxpayers,
3. Original Equipment Manufacturers,
4. Architectural and Engineering Firms, and
5. Garment Industry Taxpayers

initiatives involving Schedule M-3, the Quality Examination Process, the IDR re-design process, the role of partnerships and other pass-through entities in business operations, among many others. We are proud of our record of constructive engagement with the IRS and actively seek opportunities to engage with the agency on issues of common interest. It was in this spirit that we approached the invitation to comment on the draft research credit directives.

Overall, the dialogue at the August 6th meeting was constructive, broad-based, and wide ranging. We respectfully believe, however, that the effort to involve stakeholders and obtain their insights could have been more productive, particularly in light of the importance of the research credit to the business community and the volume of time and resources spent by taxpayers, tax authorities, and tax advisors on research credit issues. Based on our attendance and participation, we offer the following observations on the process used to solicit stakeholder input and the content of the draft directives:

1. The process used to solicit stakeholder input was compressed and limited in scope. Stakeholders simply did not have enough time during the meeting to thoroughly review and reflect upon the five proposed directives. As a result, the feedback provided was incomplete. The limited stakeholder review represented a significant missed opportunity for LB&I to leverage the presence of many of the most knowledgeable and experienced tax practitioners in the research credit area (tax advisors and in-house tax professionals alike).

   During the meeting, stakeholders raised significant concerns, particularly with the industry-specific examples contained in the draft directives. In an e-mail distributed subsequent to the meeting, LB&I invited participating stakeholders to provide written comments by close of business August 28, 2015. To its credit, LB&I expressed a desire for additional research credit examples to supplement the draft directives. The due date for comments was extended twice, first to September 8 and then to September 15. We surmise that the extensions reflect recognition that the task of drafting practical, industry-specific examples is a difficult one, requiring input from both tax experts and industry professionals. We commend LB&I for allowing stakeholders to provide written comments on the draft directives and extending the period for doing so.

2. The draft directives do not articulate their intended purpose. Absent a clear expression of purpose and how they should be used, the directives may be misused and thus create more conflicts than they resolve. In their current form, the draft directives do not contain sufficient law or sufficient facts to form the basis of a legal conclusion. The directives are not self-contained, nor could they be given the

complexities and nuances surrounding the determination of what constitutes "qualified research."

Because of their limited nature, we suspect LB&I is not attempting to advance a legal position through the draft directives (*i.e.*, that the limited authorities recited in the directives control the outcome of what constitutes "qualified research" in the fact patterns presented).[2] Rather, without more, we can only conclude the directives are intended to assist revenue agents to set up research credit examinations. Instead of leaving this to supposition, we encourage LB&I to include language in the directives instructing agents of their purpose and how they should be applied in research credit examinations.

3. Examples in the draft directives do not reflect a consistent approach or overall philosophy to research credit examinations, leaving both examiners and taxpayers without clear guidance. More specifically, the draft directives contain too many facts in some fact patterns and not enough facts in others for them to effectively assist LB&I agents in the examination process.[3] To illustrate, several examples conclude that a taxpayer had not engaged in qualified research when establishing a manufacturing process for a newly developed product. The fact patterns underlying these examples contain extensive and often times irrelevant detail about the new product's development. One proposed directive stood out. It attempted to describe the process for testing ingredients and consumer reactions to a new food product. While, generally speaking, consumer testing would not likely qualify as qualified research, ingredient testing in the development of the new food product could very well be qualified research. Nevertheless, the draft directive fails to distinguish between the two types of testing and concludes that none of the activities constitute qualified research.[4] A field agent who is not well-versed in the complexities of the research credit rules may interpret the directive as a basis for treating all the

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[2] If this is incorrect and LB&I is using the directives to express a position on the substantive research credit tax rules, we urge LB&I to present a more thorough legal analysis that supports such a position.

[3] Due to limitations placed on the stakeholder review process, we are not able to provide textual quotes from the draft directives to illustrate these points.

[4] These comments focus on factual weaknesses in the draft directives. Legal authorities quoted in the directives are likewise inadequate and too incomplete to support the legal conclusions made therein.

research activities mentioned in the fact pattern, including those that were not relevant to the conclusion, as non-qualifying activities.

The food-manufacturing fact patterns, in their present form, are also significantly oversimplified, implying that development processes are routine or repetitive in execution. Food manufacturing often involves complex industrial processes invoking many variables, such as viscosity of ingredients that react differently to different processes or designs. Such processes often satisfy the requirements for qualified research. The draft directives invite LB&I examiners to reach conclusions based on oversimplified fact patterns, as opposed to conducting a complete analysis of all the facts in issue in their cases.

Examples in the draft directives also contain a variety of unexplained terms, inviting differing interpretation by agents and taxpayers. For example, some of the fact patterns involve so called, "specs," for new products or processes. Based on discussions during the August 6 meeting, we understand LB&I intends the term "specs" to mean the taxpayer received all required technical information and was only performing simple procurement or assembly activities. Thus, the draft directives conclude no qualified research took place. Throughout various industries, the term "specs" is understood to have a much wider definition, including applications that fit squarely within the meaning of qualified research. Similarly, the terms "trial runs" and "debugging" frequently appear in draft directive fact patterns in scenarios that do not qualify for the research credit, even though such terms frequently appear in real-life applications that otherwise qualify for the credit. If these terms are not further defined in the draft directives, there is a risk examiners will rely on the directives to disallow all research involving "trial runs" and "debugging" without conducting a complete analysis of the activates actually undertaken by the taxpayer.

From the taxpayer perspective, it is critical to have clear guidance concerning the facts necessary to establish a prima facie case to support the research credits reported in their returns. At the same time, IRS examiners also need clear guidance on what facts to request and examine when testing a taxpayer's claim to the credit. As currently drafted, the directives contain editorial, non-germane, and conclusory statements that do not provide guidance to either examiners or taxpayers. To be useful, examples should be clear and neutral, enabling the examiner to ask for specific facts and the taxpayer to present them. Taxpayers and LB&I agents should not be put in a position of having to debate the meaning of examples in an industry directive. Interpretive disagreements or gaps in factual substantiation should be left for Appeals to resolve.

4. The draft directives place an inappropriate focus on penalties. Indeed, the prominence of the penalty discussion seems to imply that penalties will apply in every instance in which an examiner proposes a research credit adjustment. In our view, linking the substantive evaluation of the merits of a claimed research credit to the imposition of an accuracy related penalty is incorrect. Thus, we urge the IRS to remove the penalty discussion from the directives. Alternatively, if a penalty discussion remains in the directives, we urge the IRS to clarify that a research credit may be adjusted on examination without the assertion of penalties and that examiners should only consider additions to tax after first conducting a complete evaluation of a taxpayer's facts and legal support for the claimed credit and making an informed determination on their persuasiveness.

The issuance of industry directives could positively impact examinations of research credit claims. However, as discussed above, we believe additional work is necessary before the draft directives could achieve this objective. We encourage LB&I to reconsider the drafts and allow time for further review, comment, and revision, in particular regarding the industry-specific fact patterns. In addition, we encourage LB&I to use the directives as a means to develop and publicize safe-harbors that would help reduce the time and resources devoted to routine substantiation and documentation issues. Such innovation would allow field agents and taxpayers to refocus their time and resources on resolving substantive research credit issues, significantly improving the quality and effectiveness of the research credit examination experience.

TEI appreciates the opportunity to share its views on these issues and is prepared to offer further industry insight and experience regarding the draft directives. Clear guidance is the hallmark of sound tax administration, and we applaud the IRS for its efforts to produce guidance that can inform and help resolve research credit disputes.

Respectfully submitted,
Tax Executives Institute, Inc.

CN (Sandy) Macfarlane
International President