

ALERT- IRS CONTROVERSY

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SMEs sworn under oath in examination interviews

Executive Summary

SMEs need to be prepared

We have recently learned through a large, name-brand company in the Southeast that the IRS recently requested to interview SMEs, presumably to learn more about R&D projects, and once they got the SMEs in the room they swore them under oath. This is first time we have heard of that process in years. The article below describes more about what to expect in the new unexpected world of IRS examinations, and what you need to do to prepare for the worst.

SMEs Under Oath

Over a lunch meeting we had recently with a large, name-brand company in the Southeast, they begin describing a nightmare scenario. They had a young IRS agent assigned to their claim. The agent did not like the industry they were in and didn't feel like anything they had claimed was R&D. This is despite the fact the company has an innovation center, and is known world-wide for their products. After several years of IDRs and examination questions and answers, the IRS agent asked to speak with SMEs, to interview them. The taxpayer's representative, their accounting firm provider, and the IRS all went to the innovation center to interview SMEs. Prior to the meetings, the Tax Department and accounting firm provider had a meeting with all SMEs to tell them what to expect. While we aren't sure exactly what was told to them, it sounded like SMEs were asked to prepare to talk about business component innovation. To brag about what they had done from a technical perspective. The taxpayer was optimistic that the SME interviews might help the IRS agent understand more about what they did from a technical perspective, so that he might close the audit.

On the day of the big interviews, the IRS came into the Innovation center interview room. Under powers of IRC section 7602(a)(2) the IRS decided to make the interviews into "sworn testimony" and have it all transcribed by a court reporter. The accounting firm provider didn't know what to do, but objected to the sworn testimony. The IRS team proceeded to swear in SMEs one by one.

Witness testimony under oath is tricky. Anything said can and will be used as a "prior statement." Prior statements are used to impeach witnesses at later proceedings.

IRS agents or IRS counsel will typically swear-in a witness for one of two purposes or both: (1) to lock the witness into factual testimony, and (2) establish that the witness has no recollection of the facts. Either purpose is a disaster for the taxpayer because catching SMEs off guard is never a good thing, and most testimony will be used against the taxpayer in the facts section of a NOPA later.

So what was the nature of the questions asked that day of the SMEs at the Innovation center? They largely avoided any questions about innovation, and rather hammered the witnesses about process facts. According to this taxpayer, the SMEs were asked under oath to identify certain employees who worked for them during the period of the R&D tax credit study, which was several years prior. SMEs were asked how they came up with qualifying activities and qualifying percentages for the employees. Many SMEs were not able to answer the questions, and did not recall how the percentages were determined.

One thing that the accounting firm tried to do was object to certain lines of questioning. Problem is that neither taxpayers nor their attorneys (or accountants in this case) have the right to participate in these types of proceedings. This is purely a one-way examination. The taxpayer doesn't have a right to cross examine the witness (SME) when the IRS agent questions him/her. People who are summoned do have the right to legal counsel. But being caught off guard in this case didn't help the taxpayer or the SMEs.

I'm not exactly how the story ended for this taxpayer, but I can guess. My bet is that they received a NOPA shortly after the interviews were transcribed, and the NOPA was full of quotes from the SMEs. Quotes that established certain facts that are now hard or impossible to dispute. My guess is that this taxpayer is now facing an uphill battle with Appeals.

What is the lesson?

First, SMEs need to be educated during the R&D study, so that they are very comfortable and confident in answers they provide, or written documents that are provided to support the credit amounts. If you think the conference room interview with the provider is enough to support the study, then you need to think again. SMEs need to fully understand the four-part test, be familiar with tasks and activities of employees who work for them, and be ready to document how percentages used were determined.

We recommend trying several different approaches.

1. Let the SME see the regulations and ask questions. Provide them with a handout. Make them sign that they read it all and understand it.
2. Have SMEs provide details in their own words so they can use those later during interviews to refresh their own memories.
3. Make SMEs aware that assigning percentages for employees related to R&D activities is not just a dart throw. Provide them with a template to use. Have employees list out tasks on a percentage basis.

About MASSIE R&D Tax Credits

Jason Massie, CPA, Esq. is the President and Founder of MASSIE R&D Tax Credits. He has over 28 years of experience in leading Big Four accounting firm and national law firm practices in this area. Jason is a thought-leader and frequent speaker on R&D tax credits. He on the faculty of the BNA Bloomberg R&D Tax Credit Symposium held annually in Washington, D.C. and is a requested presenter on R&D and IRS controversy with TEI groups around the country. MASSIE R&D Tax Credits is a leading provider of federal and state R&D tax credit services. The Company focuses only on the R&D tax credit and uses best practices to ensure projects are of the highest quality. MASSIE R&D Tax Credits is based in Atlanta, GA, and facilitates a quarterly R&D Tax Credit Roundtable for some of the largest taxpayers in the country to share best practices related to R&D tax credit process.

