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STATE TAX CLASS ACTIONS

ARE YOU PREPARED?



ENERGY TAX INCENTIVES:
WHAT'S LEFT?

RESEARCH CREDIT:
IS IRS THE NEMESIS?

DISPUTE SETTLEMENT IN A PILLAR
ONE WORLD:
CHECK OUT PART TWO

CHAPTER LEADER: DANIEL SMITH

MEMBER PROFILE: MARY JONES

PERSPECTIVE: SATNAM SINGH

TAX TECH CORNER:
MINDY MCGLAUGHLIN AND
KELLY NECESSARY



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Tips From *The Art of War* to Help in Your Research Credit Battle

Some may consider the IRS a nemesis, but your battle may be gathering the necessary data and documentation to calculate and support the credit

By Jason Massie

The legendary ancient Chinese general Sun Tzu has influenced Eastern and Western military thinking, coaching strategy, and now research tax credits.¹ Some may consider the Internal Revenue Service a nemesis, but perhaps your own battle is to gather the necessary data or documentation to calculate and support the credit. To win the research credit battle, think like an architect and add these elements to your methods: planning, teamwork, smart tools, and people processes. Don't underestimate the IRS, but don't fear it, either. If you organize yourself, plan your engagement, and leverage your teammates, you will succeed. In the oft-cited words of Sun Tzu, "If you know the enemy and know yourself, you need not fear the result of a hundred battles."

PLAN—"Every Battle Is Won Before It Is Fought"

According to coach Bill Belichick, the New England Patriots have only one motivational sign in their locker room: "Every battle is won before it is fought." A true fan of Sun Tzu and *The Art of War*, Belichick loves this saying, because it reminds his team, coaches, and players that the hard work they put in today will pay off tomorrow.² Belichick, known as a thinking man, a strategist, believes that preparation is part of a master plan. He prepares for every scenario and maps out the minor details. Belichick expects his team to execute on the field but knows that planning and preparation before game day are crucial to success.

Sun Tzu's teachings and Belichick's application of them should inspire us as tax people to do more planning and preparation related to research credits and the methods we use to gather and support them.

Sometimes it is helpful to study how other professions operate in order to borrow their best practices. In this case, I challenge you to be more like architects. They don't do the "same as last year," what the accounting world knows as SALY. Architects are trained in the art and science of building design. They are great at asking questions, listening to stakeholders, and turning concepts into images and plans. Creating an architecture phase at the start of your project every year will remind you to take a step back and think about improving your process. It will challenge you to figure out ways to make the process easier for you and your technical people.

Start your architecture phase with a public document review or inspection. Look at the press releases your company has issued over the past year. Identify acquisitions, new locations, and new hires in technology areas. Are there new research expenditures or activities to investigate? Make sure to look over your notes from last year's study to improve your process—assuming you have some. Begin to engage with key stakeholders to discuss goals and timing for the study.

At this point, you are ready to create a plan. Your plan might note phases of the project on a calendar. There are two critical details to consider. First, when are your technical people available to help? Second, when do you need the calculations? Other calendar items might include training, review time, calculation preparation, and documentation inspection. Don't neglect scheduling time to put it all together. Most companies are good at getting the calculations done but fail to finish the documentation file. Letting everything sit in file folders on your hard drive will come back to haunt you upon examination. If you procrastinate and fail to prepare your final memos and notes, consider blocking off time on your calendar daily to slowly but methodically complete the work.

During your architecture phase, you could do other things, but creating a plan and preparing for the study is a great start.

TEAMWORK—"Treat Your Men as You Would Your Own Beloved Sons, and They Will Follow You Into the Deepest Valley"

The research credit may be a massive benefit to your company. It is an honor for the tax department to own such a valuable revenue stream. However, it can also be a burden. That is why you need to create a team to help you. As the old proverb goes, many hands make light work. More recently, the American author and pastor John

Maxwell has captured the idea in the title of his 2002 book, *Teamwork Makes the Dream Work*.

One reason to do an architecture phase is to help you find critical stakeholders and subject matter experts. Start by identifying whether last year's people are still with the company. Next, determine if new hires need to be engaged. Take your time with this phase, because leaving out a key person can come back to bite you. I've seen situations where not engaging the proper person on the front end hinders communication later. For example, a tax department couldn't figure out why technical people had not completed activity surveys. Upon investigation, the boss over the technical group was not in the loop and told everybody they didn't need to participate. He said, "Finance is tracking everything for us." Unfortunately, he was wrong and was confused about the purpose of the survey. Project delays could have been avoided by engaging him early in the planning.

As you set up your team, make your efforts about the company and less about the tax department. Although you will lead the planning and preparation for the study itself, you need help and buy-in from other people around the company. I can tell you from experience you need to treat all team members with respect for this relationship to succeed. It would be best if you considered their needs and schedules. For example, some calendar-year-end companies work on annual budgets, and the innovative people are super busy in the fourth quarter getting projects out the door. That would be a dark time for them and not ideal to start research credit conversations. I've also seen the opposite, where retailers or distribution companies never release new products or software in the fourth quarter for fear of messing up potential sales. In those companies, the fourth quarter might be a great time to speak with those engineers. Learning good times and bad for your teammates is critical.

I am equally surprised when tax departments send out long requests to technical leads, telling them to fill out spreadsheets. In many instances, the template spreadsheets are blank. I recommend pre-populating forms with resource names, job titles, hire and term dates, and other relevant information. Don't make your technical people do that. Think about the little ways to make this easier for your teammates. After all, they don't report to you and have many interests competing for their time. If it is just a matter of getting with human resources and payroll to fill in headcount information, then make an effort to do that

yourself. Your teammates will appreciate your help and respect you more.

SMART TOOLS—“The Control of a Large Force Is the Same Principle as the Control of a Few Men: It Is Merely a Question of Dividing Up the Numbers”

How do you eat an elephant? As Desmond Tutu, for one, has been credited with saying, the answer is “one bite at a time.” Everything related to a research credit study might seem daunting. There are so many steps and potentially large groups of people to engage. There are volumes of financial data to pull and complex calculations and workbooks to populate. Where do we begin?

We recently consulted with a company where two tax people interviewed 500 technical people a year to gather information. The tax department would spend weeks scheduling interviews, following up, asking questions, and taking notes. They felt as if they were drowning in administrative tasks.

Our solution was to help them design a “team-work hub” where their current-year research study would live. This particular company had a big push to use Microsoft Teams. We have successfully used Teams to run extensive research credit studies by using channels. Each Teams channel represented a small group—a small bite. We customized an approach for each channel and conducted small group training. By breaking up the 500 into channels, the project seemed smaller to the tax people. Plus, by using Teams, we could automate some of the administrative tasks bogging them down. Customized forms replaced interviews. Power BI dashboards produced meaningful data to review so the tax people used their time more strategically. A big plus was that they already owned the technology; we just showed them how to make it work for them!

You may want to consider other innovative tools during your study. One is ScheduleOnce, an intelligent scheduling tool that allows people to schedule meetings in seconds. For example, on your Team’s site, post your ScheduleOnce link. People can click on the link to see your open calendar times, and once they choose a time, the system will generate a calendar invite with a Zoom or Teams meeting link. If hundreds of people need to schedule time with you, this is a great way to use technology to reduce administrative labor. In addition, we use ScheduleOnce for group training. More on that below.

You may want to consider other smart tools like Microsoft Planner, Power Automate, and Power BI, which allow you to design tasks for

teammates, create auto-reminders, and track everything in dynamic dashboards. Take time to list the admin tasks you dislike related to your research credit process, and you may be surprised to find that somebody has created a smart tool to handle them for you.

PEOPLE PROCESSES—“If Words of Command Are Not Clear and Distinct, If Orders Are Not Thoroughly Understood, Then the General Is to Blame”

You’ve heard the phrase “herding cats.” Unlike sheep, cats are independent creatures and not easily convinced to follow orders or the crowd. When you are in charge of the research credit at your company, you need to design your plan and word your instructions carefully. If you have only a few dozen people to engage with during your study, then you might be able to make a mistake and recover. But if you are engaging with 500 engineers, then you’d better get it right the first time. The key here is to think like a fourth grader.

Too many times, I see tax people writing to nontax people using tax code sections, regulations, and terms of art that mean little or nothing to readers. I hate to break the news, but we tax folk are just plain dull to many outsiders. When instructions get distributed, readers might be confused at best and probably not excited about helping out. Have you ever asked software engineers if they do research and development? You might get blank stares, because the textbook definition of R&D differs considerably from that of software design. In that case, we prefer to say *innovation* or *innovate*. Ask software engineers if they innovate, and they will likely tell you how.

I’d recommend the KISS principle—as in “Keep it simple, stupid.” That principle works well in drafting instructions for technical people. Write so a fourth grader could understand. These are, after all, people at your company who are supersmart. But they still appreciate brevity and plain English.

Here is another way to think like a fourth grader: produce instructional videos. These are easy to do with Zoom or even PowerPoint. Show a survey to your screen, talk to the camera about what you need people to do or consider, and post. People are much more likely to watch an instructional video than read text these days.

We all differ in how we learn. While some like videos, others might want to learn more about the credit or read the tax code. Yes, it seems crazy, but we have had engineers ask for the code and regulations excerpts. Now, to meet all types of learners’ needs, we draft a guidebook. This document has

information about the credit, screenshots on how to complete tasks, and FAQ sections.

We also do something called user experience testing. This is one way to test out new people processes or smart tools to gain feedback. For example, if we design a new survey to help document a four-part test for a business component, we might first interview some technical people to gain insight. As they provide answers, we populate a sample answer document. As new technical people engage in the process, we provide a copy of the sample answers for reference.

Don't forget to train everybody on your new processes and smart tools. We use ScheduleOnce to block off two or three times for training. People can then select which training to attend. We record the training session and send it to those who didn't show up. We also host the video on the Teams site on the wiki page. Figure out as many ways as possible for people to learn and engage with you.

Once again, use smart tools and people processes to manage your research credit. Create situations for others to help you. Use the team effectively and efficiently. Make sure you keep things simple and provide different ways for people to interact with you.

Don't be afraid because the sky is not falling. You know what the IRS is doing. You know your facts and the law. Just make sure you pay attention to the IRS' actions and expectations.

THE IRS—"Keep Your Friends Close and Your Enemies Closer"

Everything we have discussed so far relates to your own internal process and best practices. However, don't take your eye off the ball. The IRS is aggressively waging war against taxpayers.

That war started in early 2020 when the IRS' Large Business & International (LB&I) Division announced a new compliance campaign on research credit issues. It's no accident that we use the word "campaign" here, with its military overtones. Synonyms include *crusade*, *war*, *battle*, *offensive*, *attack*. We have officially left behind the "kinder, gentler" IRS,³ which seems to be waging war despite its mission statement: "The IRS role is to *help* the large majority of compliant taxpayers

with the tax law while ensuring that the minority who are unwilling to comply pay their fair share."⁴ Doesn't that sound friendly? We are just here to "help" you. How do we reconcile "campaigns" with a desire to "help" you? When Congress enacted the research credit in 1981, it wanted to induce companies to expand research programs in the United States. In a report to President Ronald Reagan in 1984, Treasury stated: "The credit is intended to reward those engaged in research and experimentation of unproven technologies."⁵ Once again, we hear that the research credit is a "reward" from Congress, but you might have to do battle with the IRS over your reward before you claim it. Keep your eyes and ears open for what the IRS is doing at all times.

IRS ACTIONS—"Never Interrupt Your Enemy When He Is Making a Mistake"

Last summer, we had two cases where the IRS tried to defeat research credit refund claims on procedural grounds.⁶ In both cases, the government moved to dismiss based on an assertion that the taxpayer's claim lacked "specificity." In other words, the IRS argued that although Form 6765 was on file with the refund claim, the agency didn't understand why the taxpayer wanted a tax refund. To further confuse taxpayers, the cases resulted in two different standards. One court determined that the amended return and Form 6765 were enough. The other required a more detailed explanation.

The IRS was frustrated, so the Office of Chief Counsel issued Memorandum 20214101F dated September 17, 2021, released publicly on October 15, 2021. CCM 20214101F was written as an internal memo from two Area Counsel members to Cheryl Teifer, the lead executive for the research issues campaign. The CCM addresses specific information the IRS wants taxpayers to include with R&D tax credit refund claims.

Under CCM 20214101F, a valid Section 41 research credit refund claim identifies:

- the business components to which the credit claim relates;
- all research activities performed by individuals included in the claim; and
- all information each individual seeks to discover.

Furthermore, two last items must be attached: Form 6765 and a "penalties of perjury" statement. What's more, the refund claim must be submitted within the statute of limitations.

Many taxpayers, commentators, the American Bar Association, and others have argued that CCM 20214101F lacks precedential value, is only for IRS



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internal use, and contradicts the law. The ABA, in particular, has chided the IRS for issuing unauthoritative guidance and failing to engage citizens in “meaningful discussion” about the rules.⁷

We might argue that the CCM is a mistake by the IRS or even an abuse of its power, given that it never sought public comment. The reality is that agents across the IRS are now using CCM 20214101F in examinations, and its language is showing up in notices of proposed adjustment (NOPAs). You can disagree with the IRS or think it is abusing its power. That said, do you want the IRS to reject your refund claims? Is it easier to comply with the IRS’ requests or to sue it later?

Frankly, when I think about the current IRS position, I am reminded of a funny *I Love Lucy* episode. You may recall the one where Lucy and Ethel worked in a chocolate factory. As the candies came down the assembly line, the women were supposed to wrap them. As the speed of the chocolates increased, Lucy and Ethel started to lose the battle. They tried to keep up by eating candies, stuffing them in clothing, pulling them off to the side of the conveyor belt. My theory is that the IRS is both short-staffed and overwhelmed with refund claims related to research credits, and the conveyor belt is just too much to handle. Now, with the CCM in place, if taxpayers don’t comply, their refund claims never even make it to the conveyor belt. They are rejected upon receipt. I suspect somebody will sue the IRS, and we will have clarity on this issue before long. But it could be a couple of years before the dust settles. In the meantime, compliance seems easier and less costly than litigation.

DOCUMENTATION—“Don’t Depend on the Enemy Not Coming; Depend Rather on Being Ready for Him”

Where does the CCM leave us regarding our research credit claims?

The government has recognized in the past that the research credit “presents a particular burden for taxpayers because tracking eligible expenditures may necessitate taxpayers preparing and keeping records unlikely to be prepared or kept for other business purposes.”⁸ When the IRS wanted more rule-making related to documentation requirements, taxpayers were told that eligibility for the credit wasn’t contingent on meeting unreasonable recordkeeping requirements and that taxpayers had reasonable flexibility in how they substantiate their claims. So what is going on now? Why is the IRS demanding certain records?

I believe there are several reasons. One is a shortage of agents to review claims promptly.

Another is the IRS’ perception that taxpayers are not following the letter of the law when they claim research credits. The last reason is obvious when we consider the research campaigns and the CCM: the IRS uses both to sort out unworthy claims from the start so it has fewer claims to examine.

If you do this credit internally, you need to prepare for your claim to be examined. Expect an audit and plan accordingly. The best time to gather evidence related to your claim is in the year the claim is generated and not three years later when you are actually under examination. It’s easy to see why that is true, but hard for taxpayers to execute.

I recommend that taxpayers organize research credit information by business component. This is how my firm has done it for taxpayers all along. Plan to show the IRS why each business component’s activities qualify. State your case in terms of factual evidence you gather from your team members. Make sure you understand how to piece facts together to support design-related uncertainties and the activities around a process of experimentation.

One clever thing you can do to make things easier on your technical people is to help them map where documents are stored. Create a simple survey with a check-the-box section to identify what they have in their files. Ask them for some sample documents so you can collect those for future IRS examinations. Going back to planning and preparation, you need to bake time into your year to organize these items properly. Expect the IRS to examine you, and you may be surprised (and happy) when it doesn’t—rather than disappointed (and sad) when it does.

USER FEEDBACK—“Victory Is Reserved for Those Who Are Willing to Pay the Price”

It is easy to reach the end of your research credit process and put it away until next year. However, the end is when your extra efforts pay off. Spending time at the end to gain feedback from your teammates is valuable. You can prepare a list of items to improve on and then design into next year’s work plan. The continuous feedback cycle is part of improving your process and bringing it to maturity, and you need to keep up with it annually.

I’d also recommend following the feedback period with a friendly letter to management. We call it a “kudos letter.” Here you can outline who helped out and the size of the credit the team achieved for the company. Sometimes this little act of appreciation is all it takes to motivate somebody to help out next year.

Don’t cut your process short. The little things you improve each time will pay dividends.

SUMMARY—“If You Know the Enemy and Know Yourself, You Need Not Fear the Result of a Hundred Battles”

Don't be afraid because the sky is not falling. You know what the IRS is doing. You know your facts and the law. Just make sure you pay attention to the IRS' actions and expectations. Plan for those future battles now. Please don't wait until it is too late. Being in battle with the IRS during an examination already causes stress. Prepare for the battle long before it is time.

Preparation and planning are key to winning the battle, whether with the IRS or due to internal issues. A well-planned strategy of execution, including who is on your team, how your team is organized, and how you use the right people processes and smart tools, is critical. Executing on a bad plan probably won't achieve the results you seek. Spending time up front like an architect helps you lessen the battle or avoid it altogether.

Sun Tzu's timeless and practical military guidance can be applied in many situations. Study *The Art of War* to gain insight. Follow his ways to ensure victory! ♦

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Jason Massie

Endnotes

- 1 Sun Tzu was a military strategist whose *The Art of War*, a treatise written on bamboo strips dating from about 500 BC, has thirteen chapters, each on an aspect of warfare. This is one of my favorite topics to speak on at TEI events.
- 2 Khari Thompson, “Bill Belichick Uses Sun Tzu’s ‘Art of War’ as Coaching Inspiration,” *Boston.com*, November 21, 2021, <https://www.boston.com/sports/new-england-patriots/2021/11/12/bill-belichick-sun-tzu-art-of-war-coaching-patriots/>.
- 3 George W. Connelly Jr., “Whatever Happened to the Kinder, Gentler IRS?” *Chamberlain Hrdlicka Tax Blawg*, November 1, 2010, www.chamberlainlaw.com/tax-blawg/whatever-happened-to-the-kinder-gentler-irs.
- 4 Emphasis added. “The Agency, Its Mission, and Statutory Authority,” *Internal Revenue Service*, September 8, 2021, www.irs.gov/about-irs/the-agency-its-mission-and-statutory-authority#:~:text=The%20IRS%20role%20is%20to,comply%20pay%20their%20fair%20share.
- 5 Treasury Department, Report to the President, “Treasury Report on Tax Simplification and Reform” (November 27, 1984) at 301.
- 6 *Premier Tech, Inc. v. U.S.* (Fed. Dist. Ct. Utah, July 15, 2021) and *Intermountain Electronics, Inc. v. U.S.* (Fed. Dist. Ct. Utah, July 16, 2021). Both in federal court in Utah, one day apart, but different judges.
- 7 Comments on Chief Counsel Memorandum 20214101F, *American Bar Association Tax Section*, January 6, 2022, www.americanbar.org/content/dam/aba/administrative/taxation/policy/2022/010622comments.pdf.
- 8 Notice of Proposed Rulemaking, 66 Fed. Reg. 66362, 66366 (December 26, 2001).