taxnotes® federal

Volume 188, Number 11 ■ September 15, 2025

Evaluating the Reasonableness Requirement for the Research Credit

by John Andress, Dennis St. Martin, Monica Bambury, and Kevin Benton

Reprinted from *Tax Notes Federal*, September 15, 2025, p. 1767

Evaluating the Reasonableness Requirement for the Research Credit

by John Andress, Dennis St. Martin, Monica Bambury, and Kevin Benton

John Andress is a senior manager in the corporate tax solutions group of Grant Thornton Advisors LLC; Dennis St. Martin is a senior manager in the firm's Washington National Tax office; Monica Bambury is a managing director in the corporate tax solutions group; and Kevin Benton is a managing director in the Washington National Tax office.

In this article, the authors examine the history of the section 174 reasonableness requirement, its application in *Smith* and other cases, and practical considerations for taxpayers claiming section 41 research credits — including a windfall from the One Big Beautiful Bill Act.

This article represents the authors' views only and does not necessarily represent the views or professional advice of Grant Thornton Advisors LLC.

Beginning with the 2022 tax year, the Tax Cuts and Jobs Act repealed taxpayers' ability to fully deduct section 174 research or experimentation expenditures in the year they were paid or incurred.[1] Instead, these costs had to be capitalized and amortized over five years for domestic research and 15 years for foreign research, which created an inadvertent benefit for taxpayers with the concurring changes to section 280C(c).[2] Specifically, the TCJA removed the requirement that taxpayers tax-effect their section 41 research credit,[3] which in most cases resulted in an additional 21 percent permanent benefit.[4] While the One Big Beautiful Bill Act permanently restored the immediate expensing of domestic R&E and the requirement to tax-effect all research credits beginning with the 2025 tax year,[5] it may have created its own inadvertent benefit for taxpayers claiming the research credit by not reintroducing the reasonableness requirement, which had been eliminated under the TCJA, in new section 174A.

I. Background

Historically, taxpayers struggled with the proper treatment of research and development expenditures for federal income tax purposes.[6] Section 174 was enacted as a part of the Internal Revenue Code of 1954[7] to eliminate uncertainty in the tax accounting treatment of research or experimental expenditures and to encourage

[1] P.L. 115-97, section 13206(a).

[2] Joint Committee on Taxation, "Explanation of Public Law 115-97," JCS-1-18, at 145 n.686 (Dec. 20, 2018). Footnote 686 confirmed the plain language of the statute by clarifying that a taxpayer with a research credit that exceeds the amount allowable as a section 174 amortization deduction is in an "excess position" and may alternatively elect to claim the reduced research credit in lieu of reducing its section 174 expenditures for the excess amount; otherwise, taxpayers are not required to make the section 280C election to reduce their research credits by the highest corporate tax rate of 21 percent.

[3] P.L. 115-97, section 13206(a).

[4] Loren M. Opper, Christie R. Galinski, and Jeffrey L. Golds, "How Big Is the Permanent Tax Benefit in the Pending Tax Bill for Research Credit?" 14 *Nat'l L. Rev.* (Mar. 14, 2024).

[5] P.L. 119-21, section 70302.

[6] David S. Hudson, "The Tax Concept of Research or Experimentation," 45 *Tax Law.* 86 (1991). There was no special treatment for R&E expenditures until 1919, when capitalization was required.

[7] P.L. 83-591.

taxpayers to carry on research or experimentation.[8] Under the new code section, taxpayers were permitted to either (1) deduct R&E expenditures as incurred; or (2) recover the R&E expenditures over a period no less than 60 months, starting with the onset of the benefit and determined on a project basis.[9] However, Congress provided no definition of research or experimental expenditures, and there was no guidance regarding this term in prior case law.[10] Treasury issued regulations in 1957 that defined the term "research or experimental expenditures" as expenditures "which represent research and development costs in the experimental or laboratory sense."[11]

The question whether section 174 imposes a reasonableness limitation on the deductible R&E expenditures was first evaluated by the courts in *Driggs*.[12] The taxpayer, Guy K. Driggs, was a physician who offset certain R&E expenses incurred by Typesetting Systems Research Joint Venture (TSR), in which he was a partner, against income from his medical practice on his 1981 federal income tax return. TSR had hired Typography Systems International Inc. (TSI), of which Driggs was a shareholder, to conduct R&E toward the production of computer software that was intended to enhance the typesetting process. The IRS determined that TSI was a sham for federal income tax purposes and disallowed the section 174 deduction. However, the jury disagreed with the IRS's assessment and found that TSI was not a sham and that the R&E transactions were legitimate.

The IRS argued that the amount for R&E expenditures should be reduced to what it believed were reasonably incurred. Since neither the taxpayers nor the IRS identified any reasonableness standard for purposes of section 174, the district court looked to the intent of Congress and the plain language of the statute. The district court noted that the statute imposed a definitional type of limitation: If the expenditure fell within the definition, it was deductible, regardless of the amount. Therefore, absent a clearly expressed legislative intention to the contrary, the district court found that the IRS had no basis for imposing a reasonableness standard to compute the section 174 deduction.

In response to *Driggs*, Congress incorporated a reasonableness standard into section 174 through the Omnibus Budget Reconciliation Act of 1989.[13] In a House report, the Ways and Means Committee explained that it intended the reasonableness requirement under section 174 to parallel the reasonable allowance requirement for salaries and other compensation under section 162(a)(1). Further, the committee clarified that it was not intended for the reasonableness requirement to be used to question whether the research activities themselves were of a reasonable type or nature.[14] Treasury issued proposed regulations in 1993[15] and final regulations in 1994[16] that included guidance on the section 174 reasonableness requirement. While Treasury issued proposed regulations in 2013,[17] which were finalized in 2014,[18] the only effect on the reasonableness requirement was to redesignate it to reg. section 1.174-2(a)(9).

In a 2013 field attorney advice memorandum, the IRS responded to a taxpayer's request for assistance in determining whether the voluntary separation program (VSP) payments are qualified research expenditures (QREs).[19] The memorandum clarifies that regular wages paid to the separated employees were not at issue and were assumed to represent reasonable compensation expenditures paid to engineers, or other similarly employed individuals, engaged in qualified research on behalf of the taxpayer. Below is a summary of the issue and the IRS's conclusion:

[8] H.R. Rep. No. 83-1337, at 28 (1954); S. Rep. No. 83-1622, at 33 (1954).

[9] Section 59(e) was later incorporated into the code through the Tax Reform Act of 1986 (P.L. 99-514) and allowed taxpayers to capitalize and ratably deduct certain R&E expenditures over 10 years.

[10] Hudson, *supra* note 6, at 90.

[11] T.D. 6255.

[12] *Driggs v. United States*, 706 F. Supp. 20 (N.D. Texas 1989).

[13] P.L. 101-239, section 7110(d).

[14] H.R. Rep. No. 101-247, at 1203 n.12 (1989).

[15] PS-2-89.

[16] T.D. 8562.

[17] REG-124148-05.

[18] T.D. 9680.

[19] FAA 20131102F.

- Issue: Whether separation payments paid by the taxpayer to certain salaried employees who voluntarily separated from the company under a VSP initiated by the taxpayer are QREs. If the VSP payments are QREs, the taxpayer would be allowed to claim the section 41 credit for increasing research activities. The QRE determination requires an analysis of whether the payments are deductible expenses for purposes of section 174.
- Conclusion: The VSP payments are not deductible expenses for purposes of section 174. Therefore, they do not qualify as QREs for purposes of section 41 and the taxpayer should not be allowed to claim the VSP payments under section 41 as a credit for increasing research activity. Further, the taxpayer has not shown the required nexus between the payments and qualified research for the VSP payments to be considered QREs under section 41.

The IRS said that section 174(e)[20] and the regulations thereunder prohibit taxpayers from claiming a section 174 deduction for the full amount of large employee salaries when the value of the research services performed by those employees is worth far less than the amount of the payment made for the research services. The IRS noted that the taxpayer's terminated employees were paid a regular salary for the research performed, which is assumed to meet the reasonableness requirement, and received VSP payments because the employment relationship was terminated. As such, the VSP payments were determined to be unreasonable expenditures under section 174. Rather, the payments were considered as the general cost of doing business and would be an expenditure under section 162. The memorandum explains that because the VSP payment also lacked the nexus to qualified research, it would not be eligible to be a QRE.

In later field attorney advice,[21] the IRS responded to a taxpayer's request for guidance on the section 174 reasonableness requirement. The taxpayer entered into an employment agreement with an individual to serve as CEO and president for a compensation package that included base pay, bonus pay, and employee benefit plans, and reimbursement for all reasonable and necessary expenses incurred in connection with business and equity. The taxpayer claimed that 60 percent of the gross wages and other compensation reported on the individual's Form W-2 were includable as QREs for the applicable tax years. The memorandum analyzes the taxpayer's facts to address the following two issues and provide conclusions:

- Issue 1: What is the appropriate direction to be provided to an expert in evaluating the reasonableness of compensation under sections 162 and 174(a)?
- Conclusion 1: The standard for determining the reasonableness of compensation under section 162 for deduction as an ordinary and necessary business expense are different from the reasonableness standard under section 174 for treatment as a research or experimental expenditure. While the reasonableness of compensation under section 162 looks to all the activities performed by an employee, the determination under section 174 is limited to the employee's research or experimental activities.
- Issue 2: What amounts are to be included in compensation when testing for reasonableness of compensation under sections 162 and 174(a)?
- Conclusion 2: When evaluating the reasonableness of compensation, total compensation is the relevant measure. This includes taxable, nontaxable, and deferred compensation.

The memorandum appears to contradict congressional intent by emphasizing the use of an outside expert's analysis for evaluating the reasonableness of the compensation rather than considering the market factors that were in place when the agreement was executed. Ultimately, the IRS used a two-step process to determine whether wages paid to the individual met the section 174 reasonableness requirement: (1) identify the nature of the services provided and allocate the individual's time and wages to each activity; and

[20] Although the reasonableness requirement was removed for tax years beginning after December 31, 2021, this article continues to reference former section 174(e) for the ease of discussion.

[21] FAA 20154501F.

(2) evaluate if the services constituted qualified services under section 41. The IRS took the position that the compensation amount must be both reasonable and in fact payment purely for services. Further, the IRS said that a taxpayer may not claim an amount of an employee's salary representing research expenses as QREs under section 41 if the value of the research services performed by that employee is less than the amount of the payment made for the research services.[22]

A recent IRS practice aid,[23] which was designed to supplement the audit techniques guides (ATGs) issued in 2005[24] and 2008,[25] provides IRS agents with sample information document requests to address elements of a taxpayer's research credit claim. Below is an example addressing the reasonableness requirement:

- Qualified Research Activities (QRAs) — Only costs incurred conducting "qualified research" activities are eligible for the research credit. Section 41(d)(1) defines qualified research as research satisfying the four-part test. For each research activity for which research expenditures were incurred and claims as part of the research credit, provide the following:
  a. *An explanation and supporting documentation to substantiate* that the related research activities meet the following statutory requirements (known as the four-part test): (i) Expenditures may be treated as specified research or experimental expenditures under section 174, in accordance with section 41(d)(1)(A) (known as the section 174 test). Specifically, provide documents that show, for each claimed business component, what the uncertainty intended to be resolved by research was, when the uncertainty existed with respect to the research, that research was conducted in an experimental or laboratory sense, and *that the expenses were reasonable*.

[Emphasis added.][26]

Based on how the sample IDR question is structured, IRS agents are instructed to ask for an explanation and supporting documentation for the four-part test *including the section 174(e) reasonableness requirement*. We believe there is a disconnect between the information being requested and the application of the statute because the request is being made in the context of evaluating QRAs, whereas the reasonableness requirement applies to the expenditures. The IRS has made it abundantly clear, using the nexus concept,[27] that QRAs and QREs are two independent elements of the research credit and are evaluated separately.

The practice aid also includes a lead sheet issue reference guide that IRS agents are instructed to use when evaluating the taxpayer's workpapers that document the basis or method used for the research credit claim. This includes the following guidance:

> Review the nature, types, and amounts of QREs for reasonableness. Allocation of a significant amount to high wage earners, wages for administrative or sales employees, and the same allocations in multiple years may be indicative of an overstated credit.[28]

Because this guidance does not align with the language found in section 174(e) or reg. section 1.174-2(a)(9), it appears that IRS agents are being instructed to apply a broader definition of reasonableness that, without further clarification, is highly subjective in nature.

With the enactment of the TCJA, beginning for the 2022 tax years, taxpayers were required to capitalize and amortize section 174 research or experimental expenditures over specified

[22] *Id.*

[23] IRS, "SB/SE Research Credit Practice Aid" (undated).

[24] IRS, "Audit Techniques Guide: Credit for Increasing Research Activities" (June 2005).

[25] *See* LMSB-04-0508-030, "Research Credit Claims Audit Techniques Guide (RCCATG): Credit for Increasing Research Activities Under Section 41" (May 2008).

[26] Practice aid, *supra* note 23.

[27] Mary Zimmer et al., "Embracing the Nexus Concept for the Research Credit," *Tax Notes Federal*, July 14, 2025, p. 217.

[28] Practice aid, *supra* note 23.

periods. This was a fundamental shift in policy, which since 1954 had allowed taxpayers to deduct these costs in the year they were paid or incurred. Along with requiring capitalization, the requirement that section 174 expenditures be reasonable under the circumstances was removed to presumably increase the expenditures subject to mandatory capitalization.

While the OBBBA restored the ability for taxpayers to fully deduct the amount of their domestic research or experimental expenditures, under the newly formed section 174A, the bill did not restore the requirement that the expenditures be reasonable under the circumstances. Unless Congress makes a change to incorporate the reasonableness requirement into section 174A, taxpayers may have a larger pool of domestic research expenditures to immediately deduct and, to the extent they are for qualified services under section 41, treat as QREs.

II. Research Credit and Reasonableness Requirement

For purposes of the research credit, taxpayers are permitted to include in-house research expenses such as any wages paid to or incurred by an employee for qualified services.[29] The term "wages" means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with several exceptions.[30] Qualified services consist of engaging in qualified research or engaging in the direct supervision or direct support of research activities that constitute qualified research.[31] Section 41(d) contains the criteria that must be met for an activity to be qualified research.[32] One criterion directs taxpayers to the rules that have historically been under section 174 but were changed as part of the OBBBA:

- Under the TCJA, the term "qualified research" means research for which expenditures *may be* treated as specified research or experimental expenditures under section 174.[33]
- Under the OBBBA, the term "qualified research" means research for which expenditures *are* treated as domestic research or experimental expenditures under section 174A.[34]

The OBBBA changed the requirement that section 41 qualified research "may be treated as . . . section 174" expenditures to "are treated as . . . section 174A" expenditures for tax years beginning after December 31, 2024.[35]

Before the amendments in the TCJA, section 174 applied to a research or experimental expenditure only to the extent that the amount of the expenditure was reasonable under the circumstances.[36] The regulations provided:

> Section 174 applies to a research or experimental expenditure only to the extent that the amount of the expenditure is reasonable under the circumstances. In general, the amount of an expenditure for research or experimental activities is reasonable if the amount would ordinarily be paid for like activities by like enterprises under like circumstances. Amounts supposedly paid for research that are not reasonable under the circumstances may be characterized as disguised dividends, gifts, loans, or similar payments. The reasonableness requirement does not apply to the reasonableness of the type or *nature* of the activities themselves.[37]

III. Section 162(a)(1) Reasonable Allowance for Compensation

Like the research credit, the deductibility of trade or business expenses under section 162 has been among the most contentious areas of the

[29] Section 41(b)(2)(A)(i).

[30] Section 3401(a).

[31] Section 41(b)(2)(B).

[32] This is colloquially referred to as the four-part test.

[33] Section 41(d)(1)(A), pre-OBBBA.

[34] P.L. 119-21, section 70302.

[35] Taxpayers may need to evaluate historical positions taken before the 2025 tax year and consider the potential impact with this change to section 41(d)(1)(A).

[36] Section 174(e), pre-TCJA.

[37] Reg. section 1.174-2(a)(9). While "nature" is not italicized in the current regulations, it was originally italicized in T.D. 8562 when the reasonableness requirement was in reg. section 1.174-(2)(a)(6).

code. The Taxpayer Advocate Service reported that based on historical data, the courts affirmed the IRS's position in full in approximately 74 percent of cases regarding section 162 issues while taxpayers fully prevailed in approximately 2 percent of cases.[38] Perhaps this is because of the broad and subjective language in the code and regulations, which are driven by taxpayers' facts and circumstances.

As discussed, the House report accompanying the OBBBA indicates that the section 174 reasonableness requirement parallels the reasonable allowance requirement for salaries and other compensation under section 162(a)(1). A brief overview of this standard provides helpful context for understanding the section 174 reasonableness requirement.

Section 162(a)(1) states that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. Reg. section 1.162-7(a) states that there may be included among the ordinary and necessary expenses a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility for compensation payments is whether they are reasonable and are in fact payments purely for services. This test is further stated and illustrated in reg. section 1.162-7(b):

> In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.[39]

The Tax Court and several appeals courts have adopted five broad factors to evaluate the reasonableness of compensation under section 162(a)(1), with no single factor being determinative:

- role in company — the employee's position, hours worked, and duties performed;
- external comparison — compensation paid by comparable companies for similar services;
- character and condition of company — the size (for example, based on sales, net income, or capital value), business complexity, and general economic conditions;
- conflict of interest — whether a relationship exists that could allow the company to disguise nondeductible corporate distributions as compensation; and
- internal consistency of compensation — whether there is internal consistency in a company's treatment of payments to employees.[40]

In *Mayson Manufacturing*,[41] the Sixth Circuit enumerated a set of factors that differ in form but are substantively aligned with these five, as observed by the Fifth Circuit in *Owensby & Kritikos*.[42] The appeals courts have also ruled that the reasonableness of compensation must be assessed from the perspective of a hypothetical independent investor under which it is evaluated "whether an inactive, independent investor would be willing to compensate the employee as he was compensated. The nature and quality of

[38] Taxpayer Advocate Service, "National Taxpayer Advocate 2013 Annual Report to Congress," vol. 1, section 3, at 347 (Jan. 9, 2014) (identifying trade or business expenses under section 162 and related sections as the second-most litigated issue; footnote 1 clarifies that, for cases litigated from June 1, 2012, to May 31, 2013, the IRS fully prevailed in 99 out of 134 cases, while taxpayers fully prevailed in only three cases).

[39] Reg. section 1.162-7(b)(3).

[40] *See Elliotts Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983), *rev'g* T.C. Memo. 1980-282; *Owensby & Kritikos Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987); *Rapco Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996), *aff'g* T.C. Memo. 1995-128; *Pacific Management Group. v. Commissioner*, T.C. Memo. 2018-131; *Aries Communications Inc. v. Commissioner*, T.C. Memo. 2013-97; *Multi-Pak Corp. v. Commissioner*, T.C. Memo. 2010-139.

[41] *Mayson Manufacturing Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949).

[42] *Owensby & Kritikos*, 819 F.2d at 1323.

services should be considered, as well as the effect of those services on the return the investor is seeing on his investment."[43]

Although the IRS concluded in FAA 20154501F that sections 162 and 174 apply different standards for evaluating the reasonableness of compensation — section 162 considers all employee activities, while section 174 focuses solely on research or experimental activities — the courts have considered the section 162(a)(1) factors when assessing the reasonableness of compensation under section 174(e) for research credit purposes.

IV. *Smith*

The petitioners in *Smith* — Adrian D. Smith, C. Gordon Gill, and Robert J. Forest — are partners and sole owners of Adrian Smith + Gordon Gill Architecture LLP (AS+GG), which is recognized as one of the most innovative architectural firms in the world.[44] For example, Smith is credited for the design and development of the world's tallest building, the Burj Khalifa.[45] AS+GG generated research credits for activities performed during the 2007 through 2010 tax years, which were used in the 2005 through 2010 tax years via carryback and carryforward claims, to design and construct structures with physical features and sustainability levels that had never been done before. After a lengthy examination process by the IRS, only two disputed issues remained before the Tax Court: (1) the applicability of the funded research exclusion under section 41(d)(4)(H) to the six projects selected for trial, and (2) the section 174(e) reasonableness of petitioners' compensation for the 2008-2010 tax years. For purposes of this article, we focus only on the second issue.

A. Background

Smith and Gill cofounded AS+GG, and entered into an agreement of partnership effective November 2, 2006, when only a handful of architectural firms were designing supertall buildings[46] and none of them combined sustainability with supertall designs. In 2008 Smith and Gill were focused on conceptualizing a building's design with Forest serving as managing partner and overseeing the project's technical execution, client management, consultant selection, and fee structure. To provide context for the qualified research performed during the 2008-2010 tax years, the petitioners' opening brief profiles Smith, Gill, and Forest regarding their awards and professional accomplishments, education and experience, career overview, and notable projects.

AS+GG claimed research credits, using the regular method, totaling approximately $4.2 million for the 2008-2010 tax years, which were passed through to Smith, Gill, and Forest. The IRS and the petitioners agreed to reduce wage QREs for Gill and other AS+GG employees and reduce QREs based on the foreign research exclusion under section 41(d)(4)(F). By stipulation, the parties have agreed to project the results of this trial on a pro-rata basis.

In the 2008 tax year, AS+GG claimed wage-related research expenses for Smith, Gill, and Forest in the respective amounts of approximately $16.2 million, $5.9 million, and $2.6 million. The IRS has conceded that the respective amounts of $1.2 million, $813,150, and $408,593 were reasonable compensation paid to the petitioners for research in 2008. Therefore, this case involves a dispute about the reasonableness of the wage-related research expenses claimed by AS+GG in 2008 for the wages paid to the petitioners for research more than those amounts.

In calculating the research credit for self-employed individuals,[47] the term "wages" includes earned income. Earned income includes net earnings from self-employment income as

[43] *Dexsil Corp. v. Commissioner*, 147 F.3d 96, at 100-101 (2d Cir. 1998), *vacating and remanding* T.C. Memo. 1995-135, citing *Elliotts* and *Acme Construction Co. v. Commissioner*, T.C. Memo. 1995-6.

[44] Petitioners' Opening Seriatim Brief at viii, *Smith v. Commissioner*, Nos. 13382-17, 13385-17, 13387-17 (T.C. July 10, 2025). Except as otherwise noted, the facts and background discussed in this section are drawn from this brief.

[45] The Burj Khalifa in Dubai, UAE, has a total height of 829.8 meters (or 2,722 feet), and it has held the record of the tallest building in the world since its topping out in 2009.

[46] The Council on Tall Buildings and Urban Habitat defines "supertall" buildings as having an architectural height of 300 meters (or 984 feet).

[47] Section 401(c)(1).

defined in section 1402(a), which is the individual's gross income from any trade or business, less any deductions attributable to that trade or business, plus the taxpayer's distributive share of income (or loss).[48] However, the IRS argued that the wages used to compute QREs should not include profits from AS+GG because those amounts were not paid to the petitioners for the performance of qualified research.

B. Expert Testimony

Contrary to the congressional intent of using a partner's self-employment income as section 41 wage expense, the IRS relied on a subject matter expert to determine hypothetical wages based on the services provided. Accordingly, the only evidence put forth by the IRS was its proffered compensation expert, Joseph Ruble, who considered both the independent investor test[49] and the multifactor comparable worth analysis[50] to determine the reasonability of the compensation. In his opinion, the first analysis takes precedent over the second analysis.

The independent investor test generally questions whether an inactive, independent investor would have been willing to pay the amount of disputed compensation on the basis of the facts of each particular case.[51] This test allows us to decide whether the amount of compensation paid to petitioner's shareholder-employees would have been the same had they engaged in an arm's-length negotiation.[52] One important inquiry in applying this test is whether the corporation's shareholders received a fair return on their investments.[53]

In Ruble's expert opinion, the mathematical results of the independent investor test would suggest that the partners' compensation, in total, was reasonable in the context of section 162(a)(1). Therefore, Ruble found the compensation of Smith, Gill, and Forest to be reasonable under the independent investor test. The expert for the petitioners, Brent Longnecker,[54] also agreed with those conclusions.

However, the petitioners disagreed with several components of the multifactor comparable worth analysis performed by Ruble. They claimed, for example, that the analysis:

- failed to consider the entire compensation package of an executive, specifically excluding distribution/shareholder payments to comparable executives;
- did not include the highest compensated executives (CEO, COO, and CFO) at publicly traded companies and was inconsistent with the job titles selected;
- did not consider any risk assumed by AS+GG shareholders in starting their own business because Ruble believes those additional duties and risks should not influence the value of their services;
- is based on the belief that the skills possessed by the AS+GG partners are the same as architects in all architectural, engineering, construction firms, regardless of how well the company does, how big the company is, the ownership of the company, or whether the company is designing apartment buildings and libraries versus supertall structures and sustainable cities; and
- uses a definition of a market salary that equates to what compensation an employee was paid at a prior job.

In contrast, Longnecker, in evaluating the petitioners' reasonable compensation, considered industry expertise, tenure, education, time devoted to the business, whether the employees were full- or part-time, and the nature and impact of their duties within the company. Through his multifactor comparable worth analysis, Longnecker made several observations, such as:

[48] Section 401(c)(2).

[49] *Exacto Springs Corp. v. Commissioner*, 196 F.3d 833, 838 (7th Cir. 1999).

[50] *Mayson Manufacturing*, 178 F.2d 115.

[51] *Elliotts*, 716 F.2d at 1245.

[52] *Heil Beauty Supplies Inc. v. Commissioner*, 199 F.2d 193, 194 (8th Cir. 1952), *aff'g* 9 T.C.M. (CCH) 1125 (1950).

[53] *Rapco*, 85 F.3d at 954.

[54] "Mr. Longnecker has previously been accepted as an expert witness multiple times by the U.S. Tax Court and numerous other State, District, and Federal Courts. . . . Mr. Longnecker has significant familiarity with the section 174(e) 'reasonable compensation' provision, as he has previously testified as an expert in two R&D cases before the U.S. Tax Court — *Suder* and *Betz*." Petitioners' brief, *supra* note 44. Although the brief cites *Betz v. Commissioner*, T.C. Memo. 2023-84, the opinion in that case does not appear to mention Longnecker or section 174(e) subject matter expert testimony.

- drawing simple comparisons or defining other architectural firms as peers does not adequately represent the level of AS+GG's skills, experiences, accomplishments, or value;
- Smith, Gill, and Forest are "value creators," and under their leadership, AS+GG showed a 2,245 percent increase in revenue from 2007 to 2008 which, in Longnecker's opinion, was indicative of the highest level of performance by the petitioners;
- unequal distribution of income from year to year is primarily done to smooth out bad years with good years, because those things are cyclical; however, those models carry with them a lot of personal risk; and
- under the multifactor analysis relied on by the Tax Court in *Suder*,[55] the petitioners' compensation for 2008 was reasonable within the meaning of section 174(e).

C. Petitioners' Argument

The petitioners argued that Congress has removed the section 174(e) requirement[56] and that the IRS has made no assertion that the partnership percentages or any of the variables by which the petitioners' compensation are determined are faulty, flawed, not genuine, or in error. Also, the petitioners argue that the reasonableness requirement applies only to *expenses* deductible under section 174 and not to *income* under section 401(c)(2).

Over the years, the petitioners have borne the risk of failure of the partnership resulting in some lean years of compensation. Only because of significant success in some contracts, which were negotiated in good faith with highly sophisticated and well-represented third parties, that resulted in higher compensations for the petitioners in one or two years does the IRS take issue. However, the math never changed, only the amount. Under the independent investor test mandated by the Seventh Circuit, the compensation was reasonable as agreed by both parties' experts and would suggest that the partners' compensation was reasonable in the context of a section 162(a)(1) analysis.

The brief emphasizes that the petitioners have done what no one else has been able to do by designing over half of the tallest buildings in the world, including large additional superstructures that achieve net-zero energy (and in some cases net-positive energy), regardless of extreme climates. Therefore, even if the multifactor test used in *Suder* were applied to determine reasonable compensation, there is no comparable compensation for the best of the best in their field.

Further, consistent with the congressional intent of the reasonableness requirement and the specific guidance in the regulations, the petitioners did not disguise income attributable to them as shareholders of AS+GG as deductible salary payments. Rather, they complied with the requirements of section 41(b)(2)(D)(ii) to calculate their respective wages and then reduced that value by a percentage of time that they devoted to qualified research.

Finally, under the independent investor test, a taxpayer's compensation plan is presumptively reasonable unless the IRS presents credible evidence to rebut that presumption. In this case, the IRS's only evidence was the testimony of Ruble. Therefore, the IRS has failed to introduce sufficient evidence to rebut the presumption of reasonableness afforded to the petitioners.

The petitioners submitted the seriatim opening brief to the Tax Court July 10 to present the initial arguments and proposed facts, thereby initiating a structured exchange of legal arguments between the parties.[57]

V. Preceding Case Law

Although *Suder* is the only prior Tax Court case that directly addresses whether expenditures are reasonable under the circumstances and may be treated as section 41 QREs, similar concepts have been discussed in *Shami*[58] and *Apple*.[59] While the reasonableness requirement has primarily dealt with flowthrough entities, which mirrors

[55] *Suder v. Commissioner*, T.C. Memo. 2014-201.

[56] While Congress removed the reasonableness requirement for the tax years beginning after December 31, 2021, *Smith* relates to 2008-2010 research credits claimed when the statutory requirement was in place.

[57] At the time of publication, *Smith* was ongoing.

[58] *Shami v. Commissioner*, T.C. Memo. 2012-78, *aff'd*, 741 F.3d 560 (5th Cir. 2014).

[59] *Apple Computer Inc. v. Commissioner*, 98 T.C. 232 (1992).

the language in the regulations,[60] the issue was recently raised in the context of a corporation and might be addressed by the Tax Court in the near term.[61]

A. *Suder*

This Tax Court case examined several aspects of research credit claims by Estech Systems Inc. (ESI), including whether the compensation paid to its CEO was reasonable under section 174(e). Eric G. Suder, who founded ESI in the late 1980s, served as its CEO. For the 2004-2007 tax years, both Suder (90 percent shareholder) and Douglas Boyd (10 percent shareholder) claimed flowthrough research tax credits[62] based on research credits reported on ESI's timely filed returns. The IRS issued notices of deficiency to both individuals, who then petitioned the Tax Court.

ESI designed telephone systems for small and midsize businesses. During the relevant tax years, it claimed QREs for 76 projects. The Tax Court reviewed 12 of those projects, which the parties agreed were representative.[63] The court also evaluated whether Suder's compensation was reasonable under section 174(e). As ESI's highest-paid employee, Suder accounted for approximately two-thirds of the company's wage QREs during the relevant credit years. His compensation included a base salary and bonuses tied to ESI's growth, overall value, and cash flow.

Based on expert testimony, the Tax Court found Suder's compensation unreasonable under section 174(e) and redetermined ESI's claimed QREs based on amounts it determined reasonable. Citing *Owensby & Kritikos*,[64] the Tax Court said that the question of reasonableness is one of fact that must be resolved on the basis of all the facts and circumstances.[65] The Tax Court considered nine factors[66] within the framework of four categories when evaluating the reasonableness of Suder's compensation under section 174(e): (1) qualifications and work duties, (2) wages relative to stockholdings and income, (3) wages as research expenses, and (4) wages of other CEOs.[67]

According to the Tax Court, the most important factor was how Suder's compensation for 2004-2007 compared with the compensation paid to CEOs similar to him by companies similar to ESI for performing similar services.[68] The Tax Court heard expert testimony from both sides and found Longnecker's report more reliable because he was an expert in executive compensation. Longnecker compared Suder's compensation with compensation of CEOs in six different databases and testified at trial that Suder should be compensated in the 90th percentile for the credit years. In his computation of reasonable compensation for Suder, Longnecker included a base salary, an annual incentive, a long-term incentive, and royalties on gross revenue. The Tax Court generally agreed with Longnecker's assessment and accepted his computations of base salaries, annual incentives, and long-term incentives at the 90th percentile because Suder is a visionary who built ESI from the ground up.[69]

However, the Tax Court found that Suder's part-time work schedule — averaging 20 to 30 hours per week during the credit years — raised doubt about the reasonableness of his

[60] Reg. section 1.174-2(a)(9).

[61] Motion for Partial Summary Judgment at 11 n.10, *Facebook Inc. v. Commissioner*, No. 12738-18 (T.C. May 30, 2025).

[62] ESI is a small business corporation taxed as an S corporation.

[63] The Tax Court found that 11 of the 12 representative projects met the section 41(d) four-part test and that ESI's claimed QREs were substantiated.

[64] *Owensby & Kritikos*, 819 F.2d at 1323.

[65] *Suder*, T.C. Memo. 2014-201, at 63. The Tax Court noted that *Owensby & Kritikos* was decided by the Fifth Circuit — the same appellate court that would have jurisdiction for an appeal.

[66] In *Owensby & Kritikos*, 819 F.2d 1315, the Fifth Circuit cited *Mayson Manufacturing*, 178 F.2d 115, in outlining the factors to determine section 162(a)(1) reasonable compensation: (1) the employee's qualifications; (2) the nature, extent, and scope of the employee's work; (3) the size and complexities of the business; (4) a comparison of salaries paid with the gross income and net income; (5) the prevailing general economic conditions; (6) comparison of salaries with distributions to stockholders; (7) prevailing rates of compensation for comparable positions in comparable concerns; (8) the salary policy of the taxpayer as to all employees; and (9) for small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years.

[67] While the Fifth Circuit in *Owensby & Kritikos* evaluated the reasonableness of compensation under section 162(a)(1), the Tax Court's consideration of these factors in *Suder* when assessing the section 174 reasonableness requirement demonstrates their relevance in that context. This aligns with the House report accompanying the OBBBA, which explains that the section 174 reasonableness requirement is intended to parallel the reasonable allowance requirement for salaries and other compensation under section 162(a)(1).

[68] *Suder*, T.C. Memo. 2014-201, at 67.

[69] *Id.* at 73. The Tax Court found Longnecker's inclusion of royalty amounts in Suder's compensation to be erroneous.

compensation. Citing discussion in *Owensby & Kritikos* that addressed whether payments to shareholders may be disguised dividends, the Tax Court noted that Suder's high compensation, which ranged from 4.1 to 6 times ESI's ordinary business income during the credit years, appeared, in part, unreasonable. The Tax Court distinguished Suder's compensation from that of the chief architect, noting that Suder's wages were roughly proportionate to his ownership interests (when compared with Boyd — ESI's other shareholder) and fluctuated from year to year. Further, the Tax Court found no evidence in the record that Suder's wages were tied to his contribution to R&D at ESI, noting that his wages were significantly higher in the credit years, despite not being named as an inventor on any new patent applications filed in that period.

Equally, if not more, important is how the compensation compares with that of individuals in similar roles performing similar activities in a similar industry. The Tax Court's frequent citation of *Owensby & Kritikos* and the nine factors for evaluating the reasonableness of compensation under section 162(a)(1) may indicate alignment between the reasonableness requirement under section 174(e) and the section 162 reasonable allowance requirement, offering taxpayers a broader framework for evaluating and substantiating compensation under section 174.

B. *Apple*

The Tax Court's 1992 decision in *Apple*,[70] while not directly addressing the section 174(e) reasonableness requirement, offers meaningful insight into how compensation — particularly noncash compensation — should be evaluated in the context of research expenditures. In *Apple*, the court held that stock option spreads constituted wages under section 3401(a), making them includable under section 41 and potentially deductible under section 162, subject to the applicable reasonableness standards. The court emphasized that wages for purposes of sections 174 and 41 should be interpreted consistently, and that Congress's incorporation of section 3401(a) into the research credit framework reflected an intent to include noncash compensation, so long as it was remuneration for services performed.

The court's reasoning supports a two-part framework for evaluating compensation under the former provision. First, the compensation must qualify as wages under section 3401(a) and be reasonable in amount for the services rendered. *Apple* affirms that even substantial or equity-based compensation can meet this threshold, provided it reflects actual services performed and it is not merely a function of ownership or profit sharing. This aligns with the broader principle that total compensation must be justifiable considering the employee's role, responsibilities, and contributions.

Second, to the extent compensation is included in QREs, it must be reasonably allocable to research activities. Although the court in *Apple* did not parse the allocation of compensation to specific functions, its emphasis on the service-based nature of qualifying wages reinforces the idea that only compensation tied to actual research services should be included. Therefore, documentation, time tracking, and a nexus between compensation and research remain essential to meet the reasonableness requirement.

Apple thus provides a useful interpretive lens for applying the reasonableness requirement, even after its repeal. The IRS will likely continue to challenge the reasonableness of compensation including stock options. *Apple* also supports that noncash compensation can be treated as wage QREs when grounded in services performed, and it underscores the importance of aligning compensation with the substance of the work — particularly for high-compensation employees or equity-based pay structures.

C. *Shami*

Although this case does not directly address the reasonableness requirement under section 174(e), *Shami* illustrates how the principles of the reasonableness requirement can operate in practice. Farouk Systems Inc. claimed research credits based on wages paid to its founder (Farouk Shami) and executive vice president (John McCall), asserting that they spent most of their time on qualified research. However, the Tax Court found that the company failed to substantiate how much time, if any, these

[70] *Apple Computer Inc. v. Commissioner*, 98 T.C. 232 (1992).

individuals devoted to qualified research activities. It rejected vague and self-interested testimony, found no credible documentation, and declined to estimate allocable wages under the *Cohan* rule[71] in the absence of a reasonable evidentiary foundation.

The court's reasoning, though framed under section 41, reflects the essence of section 174(e) in that compensation is reasonable under the circumstances only if it is tied to the research services performed. The decision underscores that reasonableness is not a function of title, compensation level, or general involvement in product development — it is a function of evidence. Without credible records or third-party corroboration, even high-level executives with technical influence within the R&D process cannot satisfy the reasonableness requirement.

On appeal, the Fifth Circuit affirmed the Tax Court's findings, reinforcing that the burden of proof lies squarely with the taxpayer. The appellate court rejected the argument that the Tax Court imposed an unduly high "standard of exactitude," clarifying that the Tax Court had simply applied the statutory requirement to substantiate QREs. It also upheld the Tax Court's discretion not to estimate expenses using the *Cohan* rule, and emphasized that estimation is appropriate only when there is a credible basis. The Fifth Circuit further rejected the notion that upper-tier management or patent authorship alone could establish entitlement to research credits, reiterating that supervisory roles must involve direct oversight of research and not just organizational leadership.

Shami serves as a cautionary reminder that substantiation is the foundation of reasonableness, and that courts will not bridge evidentiary gaps with assumptions or approximations. Further, compensation should be tied to specific, documented research activity and supported by credible, contemporaneous evidence. Finally, while the Tax Court's ruling in *Shami* emphasizes the importance of substantiation in determining reasonable compensation, its decision in *Suder* suggests that substantiation alone is not determinative.

[71] *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

VI. Considerations

Although Congress removed the section 174 reasonableness requirement with the TCJA beginning with the 2022 tax year, taxpayers should consider *Smith* and other case law when evaluating if expenditures are eligible to be treated as section 41 QREs. Taxpayers may benefit from evaluating research credit methods, analyzing qualified employee services, and examining qualified employee compensation. Most importantly, taxpayers should coordinate the following considerations with the other provisions of the OBBBA (and existing law) to model the potential federal and state impact for purposes of tax provisions, tax returns, financial statements, and tax planning.

A. Evaluating Research Credit Methods

Taxpayers that have historically excluded QREs that did not meet the reasonableness requirement or that have received IRS examination adjustments for not meeting the requirement should evaluate their methods for computing and documenting the research credit. Taxpayers may have an opportunity to file amended returns for the 2022 tax year and forward, provided the statute of limitations[72] has not closed, to claim additional expenditures that were capitalized for section 174 but not treated as QREs generating a research credit. However, taxpayers seeking a refund must include the required information to establish a valid research credit claim.[73]

Further, when including the QREs that would otherwise have been disallowed based on historical section 174(e), the taxpayer must make the necessary base amount adjustments to satisfy the consistency rule.[74] That rule under section 41 states:

> Notwithstanding whether the period for filing a claim for credit or refund has expired for any taxable year taken into

[72] Section 6511(a) states that a credit or refund of an overpayment of tax shall be filed by the taxpayer within three years from the time the return was filed or two years from the time the tax was paid, whichever expires later, or if no return was filed by the taxpayer, within two years from the time the tax was paid.

[73] FFA 20214101F.

[74] Section 41(c)(5).

account in determining the fixed-base percentage, the qualified research expenses taken into account in computing such percentage shall be determined on a basis consistent with the determination of qualified research expenses for the credit year. The Secretary may prescribe regulations to prevent distortions in calculating a taxpayer's qualified research expenses or gross receipts caused by a change in accounting methods used by such taxpayer between the current year and a year taken into account in computing such taxpayer's fixed-base percentage.

Further guidance regarding the application of the consistency rule, based on the method used to compute the research credit, is found within the regulations:

- Taxpayers using the regular method: In computing the credit for increasing research activities for tax years beginning after December 31, 1989, QREs and gross receipts taken into account in computing a taxpayer's fixed-base percentage and a taxpayer's base amount must be determined on a basis consistent with the definition of QREs and gross receipts for the credit year, without regard to the law in effect for the tax years taken into account in computing the fixed-base percentage or the base amount. This consistency requirement applies even if the period for filing a claim for credit or refund has expired for any tax year taken into account in computing the fixed-base percentage or the base amount.[75]
- Taxpayers using the alternative simplified credit method: QREs for the three tax years preceding the credit year must be determined on a basis consistent with the definition of QREs for the credit year, without regard to the law in effect for the three tax years preceding the credit year. This consistency requirement applies even if the period for filing a claim for credit or refund has expired for any of the three tax years preceding the credit year.[76]

When evaluating if the consistency rule requires taxpayers to make a base period adjustment, taxpayers must be aware that they must keep permanent books of account or records and make that information available for inspection by the IRS to substantiate the research credit claim.[77] As demonstrated in *Research*,[78] taxpayers must be able to substantiate the QREs incurred during the base period through contemporaneous documentation. This could become increasingly challenging for taxpayers computing the research credit using the regular method, particularly taxpayers that compute the fixed base percentage using the ratio of QREs to gross receipts for the 1984-1988 tax years to demonstrate that the consistency rule has been met.

If qualified employees exercised stock options in a credit year, taxpayers should evaluate their method for computing the QREs and compare their facts and analysis with *Apple*. Taxpayers may generally compute QREs using a three-step process:

- Compute the credit year QREs by multiplying an employee's taxable wages (less stock option compensation) and the percentage of time the employee spent performing qualified services.[79]
- Compute the QREs related to the stock options by multiplying an employee's stock option spread and the percentage of time the employee spent performing qualified services in the year the stock options were granted.
- Sum the QREs from the two prior steps and compare it with the total taxable wages for the employee. If the ratio of QREs to total wages for the employee is at least 80 percent, the wage "substantially all" rule is met and

[75] Reg. section 1.41-3(d)(1). Examples illustrating the application consistency rule are provided in reg. section 1.41-3(d)(2).

[76] Reg. section 1.41-9(c)(2). Although the consistency rule was reassigned from section 41(c)(6) to section 41(c)(5) with P.L. 115-141 (Mar. 23, 2018), the title of this paragraph still refers to "section 41(c)(6) applicability" because the regulations were last updated with T.D. 9712 in February 2015.

[77] Reg. section 1.6001-1(a) and (e).

[78] *Research Inc. v. United States*, 76 A.F.T.R.2d (RIA) 95-5688 (D. Minn. 1995).

[79] Reg. section 1.41-2(d)(1).

100 percent of the taxable wages for the employee can be included as QREs when computing the research credit.[80]

Taxpayers that apply this method to compute QREs for a credit year must also evaluate their facts for the base period and determine if a consistency rule adjustment is required.

Also, in evaluating the process of experimentation "substantially all" rule at the business component level,[81] taxpayers will need to evaluate how the nexus of the QREs being derived from the stock compensation spread aligns with the appropriate business component. Like the approach used to compute the qualified percentage, taxpayers could look to the business components that the employee worked on in the year the stock options were granted. Taxpayers should be prepared to substantiate the qualification of the business components, which may include providing an explanation of how the four-part test was met and contemporaneous documentation. As part of the credit year analysis, taxpayers must evaluate the availability of this information because they have the burden of proof for substantiating the credit and the underlying QREs.[82]

B. Analyzing Qualified Employee Services

Taxpayers are familiar with the need to analyze the activities performed to determine if they are qualified for purposes of sections 41 and 174. The regulations clarify that whether expenditures qualify as research or experimental expenditures under section 174 "depends on the *nature of the activity* to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents" (emphasis added).[83]

Taxpayers should leverage the language in the code and regulations as a framework to provide context for analyzing the nature of the services provided. For example, evaluating if the activities align with one or more of the qualified services categories under section 41,[84] or if any services are excluded from the definition of R&E under the section 174 regulations.[85]

Historically, taxpayers have experienced IRS agents trying to audit research credit claims based on an analysis of qualified employees' job titles. That approach has been applied to all qualified employees, not just when the reasonableness requirement has been raised. It is contrary to guidance within the ATG[86] and the concept of the section 41 credit being an activity-based credit. Taxpayers can leverage the activity-level detail to help rebut this approach and defend the qualification determinations underlying the research credit claim.

C. Examining Qualified Employee Compensation

Regardless of the TCJA's removal of the reasonableness requirement, the OBBBA's failure to restore it in section 174, and the OBBBA's creation of section 174A, taxpayers should still examine employee compensation for purposes of computing QREs. While the definition of wages eligible for section 41 treatment is broad, taxpayers may need to adjust QREs based on the following factors:

- VSP payments;[87]
- deduction limitations for certain excessive employee remuneration;[88] and
- incentive policy documents, employee contracts, and similar documents that prove the nexus between the employee payments

[80] Reg. section 1.41-2(d)(2).

[81] Reg. section 1.41-4(a)(6). For more considerations, see John Andress et al., "Examining the 'Substantially All' Rule for the Research Credit," *Tax Notes Federal*, Apr. 21, 2025, p. 481.

[82] *Eustace v. Commissioner*, T.C. Memo. 2001-66, *aff'd*, 312 F.3d 905 (7th Cir. 2002).

[83] Reg. section 1.174-2(a)(1).

[84] Section 41(b)(2)(B). The term "qualified services" means services consisting of engaging in qualified research or engaging in the direct supervision or direct support of research activities that constitute qualified research. While each category of services is qualified, the IRS may require taxpayers to identify QREs by category during an audit. Further, certain taxpayers must report QREs by business component and qualified services category to claim the research credit beginning with the 2025 tax year.

[85] Reg. section 1.174-2(a)(6)-(8).

[86] LMSB-04-0508-030, *supra* note 25, at ch. 4.a, "Wages." The ATG states an important caveat: "Determinations as to whether an employee is (or is not) engaged in qualified services, should not be based solely on job descriptions or titles."

[87] FAA 20131102F, *supra* note 19.

[88] Section 162(m). Taxpayers should also be aware that the OBBBA changed the aggregation rules beginning with the 2026 tax year. *See* P.L. 119-21, section 70603.

and underlying research or nonresearch activities.

When computing QREs for a covered employee[89] with remuneration above the $1 million limitation, taxpayers should multiply the percentage of time the employee spent performing qualified services, adjusted for the wage "substantially all" rule,[90] by the $1 million limitation. Taxpayers also may need to consider the factors discussed in *Alpha Medical* to address any potential inquiries during an examination.[91]

D. Assessing Related OBBBA Provisions

In addition to allowing taxpayers to fully expense domestic research or experimental expenditures paid or incurred in tax years beginning after December 31, 2024, the OBBBA included several provisions that taxpayers should consider regarding research or experimental expenditures and the research credit:

- Transition rules provide an election for taxpayers to deduct unamortized domestic section 174 expenditures paid or incurred in 2022 through 2024 either entirely in the first tax year beginning after December 31, 2024, or ratably over two tax years beginning after December 31, 2024.
- For tax years beginning after December 31, 2024, section 280C was restored to the pre-TCJA requirement that taxpayers claiming the gross research credit reduce their domestic research or experimental expenditures by the amount of the gross credit or otherwise elect to claim the reduced research credit.
- Within one year of the bill's enactment,[92] small businesses that meet the gross receipts test under section 448(c) for the first tax year beginning after December 31, 2024, can elect to retroactively apply section 174A to domestic research or experimental expenditures paid or incurred in tax years beginning after December 31, 2021. Making the election requires filing an amended return for each affected tax year. Small businesses that elect to retroactively apply section 174A must also retroactively apply the reinstated pre-TCJA requirements of section 280C (discussed above) and are eligible to make or revoke the section 280C(c) election on the amended returns.

Also, taxpayers can continue amortizing domestic section 174 expenditures that were paid or incurred during the 2022 through 2024 tax years over the remaining five-year period.[93] It would be prudent for taxpayers to begin assessing these provisions while monitoring if any procedural guidance is issued to provide additional clarity. Modeling and comprehensive analysis are important to understand the downstream impacts of section 174A and the transition rules on other tax-related calculations.

VII. Conclusion

If Congress intended to incorporate the reasonableness requirement into section 174A, which is effective for tax years beginning after December 31, 2024, it will need to take action to address this issue. However, because it appears that this would not easily be remedied through a technical correction,[94] we are uncertain of the likelihood that section 174A would be updated to include the reasonableness requirement.

When computing section 174A expenditures and a section 41 research credit for the 2025 tax year, it would be prudent for taxpayers to evaluate the potential impact of the reasonableness requirement should it be restored.

[89] Section 162(m)(3).

[90] Reg. section 1.41-2(d)(2).

[91] *Alpha Medical Inc. v. Commissioner*, 172 F.3d 942 (6th Cir. 1999).

[92] P.L. 119-21, section 70302.

[93] Taxpayers must continue amortizing foreign section 174 expenditures over the remaining 15-year period.

[94] JCT, "Overview of the Revenue Estimating Procedures and Methodologies," JCX-1-05, at 34 (Feb. 2, 2005). "The Joint Committee staff defines a technical correction as legislation that is designed to correct errors in existing law in order to fully implement the intended policies of previously enacted legislation. The principal factor in determining whether a provision is technical is the original intent of the underlying legislation. Once it is determined that the existing statute does not properly implement legislative intent, and that the proposed change conforms to and does not alter the intent, the provision is deemed to be technical."

This analysis should include performing a risk assessment and, depending on the taxpayer's risk profile, taking the appropriate tax position and reevaluating it each tax year.[95] ■

[95] The foregoing information is general in nature and is based on authorities that are subject to change. It is not, and should not be construed as, accounting, legal, tax, or professional advice provided by Grant Thornton Advisors LLC. This material may not be applicable to, or suitable for, the reader's specific circumstances or needs and may require consideration of tax and nontax factors not described herein. Contact your tax professional before taking any action based on this information. Changes in tax laws or other factors could affect, on a prospective or retroactive basis, the information contained herein; Grant Thornton Advisors LLC assumes no obligation to inform the reader of any such changes. This article represents the authors' views only and does not necessarily represent the views or professional advice of Grant Thornton Advisors LLC. Grant Thornton Advisors LLC and its subsidiary entities are not licensed CPA firms.