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**THE IMPACT OF UNION
CARBIDE ON RESEARCH
CREDIT CLAIMS**

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NEW DEVELOPMENTS**THE IMPACT OF UNION CARBIDE ON RESEARCH CREDIT CLAIMS**

In *Union Carbide Corp.*, TCM 2009-50, the Tax Court ruled on several issues with respect to the research credit under Section 41 that have been contentious for taxpayers in recent IRS examinations. While the court disallowed a significant portion of the qualified research expenditures (QREs) (and as of 3/23/09 the parties had failed to settle on the amount of the research credit to be allowed), on many notable issues the court ruled in favor of Union Carbide. Douglas M. Mueller, CPA, president of St. Louis-based CPA and business advisory firm MPP&W, P.C., and Michael J. Devereux II, a member of the firm's tax credit group, analyze the consequences of this decision for other taxpayers.

Background. In a prior negotiated agreement between Union Carbide and the IRS, Union Carbide was allowed research credits in accordance with Section 41 for tax years 1994 and 1995. In an amended petition, Union Carbide claimed additional research credits under Section 41 of more than \$3.6 million and \$4.7 million for 1994 and 1995, respectively, based on additional QREs of more than \$56.2 million for 1994 and \$145.4 million for 1995. These additional credits were derived from 106 research projects conducted during those two tax years.

For purposes of resolving the matter, Union Carbide and the Service agreed to assess a sampling of the five largest research projects. In addition, the court would rule on whether Union Carbide complied with the consistency requirement in accordance with Section 41(c)(6) (Section 41(c)(4) at the time of the claimed credits).

The Tax Court found that two of the five representative projects constituted qualified research in accordance with Section 41(d) for additional qualified research wages of \$835 and \$210 for 1994 and 1995, respectively. Further, the court found that Union Carbide complied with the consistency requirement in re-

gard to the two research projects it determined to be qualified.

The court's findings. While the Tax Court did not allow a significant portion of the additional qualified expenditures claimed (the qualified wages were less than 1% of the additional expenditures claimed), it ruled on several issues that taxpayers have found to be controversial when dealing with IRS examinations.

Application of TD 9104. The court ruled on the definition of the "discovery test" and differentiated between the "discovery test" as applied in past cases,¹ and the "technological in nature" test as found in TD 9104, 12/31/03.²

In note 42 of its opinion, the Tax Court ruled that prior to the promulgation of Reg. 1.41-4(a)(3)(ii), it had held "that this test had a 'discovery' component that was to be construed more narrowly than the discovery test of sec. 174 and required that the taxpayer discover information that went beyond the current state of knowledge in the relevant field." In quoting the current Regulations promulgated under TD 9104, the court said that a "determination that research is undertaken for the purpose of discovering information that is technological in nature does not require the taxpayer be seeking to obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research." The Tax Court noted that "[w]hile these regulations apply to years ending on or after Dec. 31, 2003, [Reg. 1.41-4(e)], [the IRS] has taken the position that [it] will not challenge return positions that are consistent with these final regulations and therefore that the current regulation should govern the outcome of this case, see T.D. 9104, 2004-1 C.B. 406, 410. Accordingly, [the IRS] concedes that [Union Carbide] satisfies the 'technological in nature' test as long as the information sought to be discovered is in

fact technological, and we accept this concession." (Emphasis added.)

This ruling could assist taxpayers that are at odds with the IRS over the "technological in nature" test in ongoing audits of all tax years, especially those prior to the issuance of TD 9104. In addition, this ruling may be relevant to taxpayers who were unable to use credits generated in years prior to 2003 due to being in a loss or alternative minimum tax position. Assuming taxpayers can substantiate additional qualified expenditures in these years, taxpayers may consider adjusting their credit carryforwards by the amounts of these additional expenditures, now considered to be eligible expenditures under the current Regulations.

Uncertainty test. In regard to one of the research projects for which QREs were claimed, the Service argued that Union Carbide's additional QREs related to the activities performed "fail[ed] the section 174 test because [Union Carbide] was certain that it could produce [the business component]." The Tax Court ruled, however, that Union Carbide met the Section 174 test: "We agree with [the IRS] that some of the documentary evidence indicates that [Union Carbide] was confident that at some point it would be able to produce [the business component] on a commercial scale and sell [that component] to licensees. Furthermore, we find that [Union Carbide] generally found [the business component] to work as well as or better than [the prior methodology]. However, this does not end our inquiry. Even if [Union Carbide] was certain that it was capable of using [the business component] commercially, the section 174 test may also be satisfied 'if the information available to the taxpayer does not establish the ... appro-

NOTES

¹ See *Norwest Corp.*, 110 TC 454 (1998), and *Eustace*, TCM 2001-66, *aff'd* 312 F.3d 905, 90 AFTR2d 2002-7661 (CA-7, 2002).

² See Arkin and Eberle, "The New Research Credit Final Regs.—What's Gone, What's New, and What's Missing," 100 JTAX 144 (March 2004).

prate design of the product. [Reg. 1.174-2(a)(1).]” (Emphasis added.)

This ruling will benefit taxpayers under examination where the Service erroneously asserts that taxpayers are ineligible for the research credit when they were certain they could accomplish a research objective, but were uncertain as to the method of achieving its objective or the appropriate design of the business component in question.

Use of estimates in allocating wages. In substantiating its claim, Union Carbide “determined wage rates for the employees who were primarily involved in the projects and multiplied those rates by the number of hours that the employees estimated they had worked on the project.”

The Tax Court found the testimony and attestation by the employees to the time spent on qualified research to be credible. Nevertheless, the court differentiated between expenditures that had been attested to and those that had not. The Court found “that [Union Carbide] has satisfied its burden and may treat as wage QREs \$835 and \$210 for 1994 and 1995, respectively. However, [one employee] did not testify as to how much time, if any, he spent on the [research project]. Accordingly, [Union Carbide] has not satisfied its burden of proving that [this employee] spent two hours engaged in qualified research with respect to the [research project] in 1994 and may not claim his wages as QREs.”

Thus, *the only qualified research expenditures allowed* by the Tax Court were based on oral testimony of the employees performing the qualified research activities. This ruling may be the most consequential for taxpayers under audit that relied on time estimates in order to quantify the qualified wages in its claim. Accordingly, taxpayers that did not contemporaneously record the amount of time spent on the qualified research activities still may be eligible for the research credit.

Use of estimates in computing base period QREs. In attacking the base period documentation, the Service argued that Union Carbide “relied upon esti-

mates and assumptions for a large number of [activities],” which IRS characterized as legally impermissible.

The Tax Court, however, stated that Reg. 1.41-4(d), relating to the substantiation of the credit, “does not require that a taxpayer substantiate its research credit claim with any particular types of documents but requires the taxpayer ‘retain records in sufficiently usable form and detail to substantiate that the expenditures are eligible for the credit.’” The court found that the documents Union Carbide produced—which, according to the IRS, relied on estimates—were sufficient to substantiate its claim.

The Service also argued that the expert witnesses’ calculation of QREs was flawed, as it erroneously included expenditures that were not qualified expenditures. The court, in allowing the expert witnesses’ calculation (with some agreed-on adjustments), stated that “the fact that the two runs that [the IRS] specifically criticizes [the expert] for missing do not satisfy the requirements of section 41(d) suggests that [Union Carbide’s] concession of these runs sufficiently broadens [Union Carbide’s] definition of ‘qualified research’ for the base period so that it is at least as broad as, if not broader than, the Court’s interpretation of section 41(d).” Citing the reasoning of *Cohan*, 39 F.2d 540, 8 AFTR 10552 (CA-2, 1930), the Tax Court stated that it accepted Union Carbide’s “list of identified runs, including concessions, as a *close approximation* of all of the qualified research activities that occurred during the base period.” (Emphasis added.)

This ruling seemingly gives taxpayers more flexibility in calculating their base period QREs. In addition, the ruling provides support for taxpayers that do not know the exact amount of qualified expenditures during the base in accordance with TD 9104. By using contemporaneous documentation to corroborate *conservative* estimates, taxpayers can substantiate their QREs incurred in the base period.

The consistency requirement. The Tax Court ruled that in order to comply with the consistency requirement in accordance with Section 41(c)(6), “the

taxpayer must include the same types of activities from the credit year and the base period when identifying qualified research activities and include the same types of costs as QREs for the credit year and the base period.”

In reviewing an earlier order, the court again ruled in favor of Union Carbide. The IRS argued that Union Carbide “was required to calculate its QREs for the base period for *the entire controlled group* on a consistent basis with its QRE calculation for the claim projects. This would require [Union Carbide] to include in its revised research credit computations the QREs incurred not only by [Union Carbide], but also the other members of [Union Carbide’s] controlled group.” (Emphasis added.)

The court confirmed, however, its earlier decision that “the consistency rule applies to the determination of QREs for each member of the controlled group while the aggregation rule of section 41(f)(1) refers to the determination of the overall credit ... and there is no indication in the statute or the legislative history that all members of a consolidated group must calculate their QREs in the same way.”

This ruling seems to give taxpayers more flexibility in calculating their base period QREs while adhering to the consistency requirement in accordance with Section 41(c)(6). Moreover, by including only qualified expenditures that are consistent with the expenditures being claimed in the credit year, taxpayers can exclude qualified expenditures related to base period qualified expenditures that are not consistent with the qualified expenditures being claimed in the credit year, thus potentially lowering the fixed-base percentage.

Conclusion. While *Union Carbide* may not be considered a taxpayer “victory” due to the amount of expenditures that were disallowed as QREs in accordance with Section 41, there are many aspects in which the court ruled in Union Carbide’s favor, thus creating opportunities for clients performing qualified research. ■