

Research & Experimentation Tax Credit News

Last month, the United States Tax Court ruled on several issues of particular interest to Taxpayers in recent IRS examinations with respect to the Research and Experimentation Tax Credit. Following are details from an article written by MPP&W, P.C.'s Doug Mueller and Michael J. Devereux II that will appear in a future issue of the national publication *The Journal of Taxation*.

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Recent Tax Court Ruling May Assist Taxpayers in Substantiating Their Research Credit Claims Upon Audit

by Douglas M. Mueller, CPA and Michael J. Devereux II

On March 10, 2009, the United States Tax Court released T.C. Memo. 2009-50 and ruled on several issues that have been contentious for Taxpayers in recent IRS examinations with respect to the Research Tax Credit under IRC §41.

While the Court disallowed a significant portion of the qualified research expenditures in *Union Carbide Corporation and Subsidiaries*, TC Memo 2009-50, and at the time of this writing the parties have likely failed to settle on the amount of the research credit to be allowed for tax years 1994 and 1995 (the years in question), there are many notable issues for which the Court ruled in favor of Union Carbide Corporation and Subsidiaries (hereafter "Union Carbide" or "Taxpayer").

THE COURT'S FINDINGS

While the Court did not allow a significant portion of the additional qualified expenditures claimed (the qualified wages were less than one percent of the additional expenditures claimed), it ruled on several issues that Taxpayers have found to be controversial when dealing with examinations by the IRS. The following analysis discusses these issues.

Application of Current Regulations

The Court ruled on the definition of the "discovery test" and differentiated between the "discovery test" as applied in past court cases, and the "technological in nature" test as found in current regulations. Prior to the issuance of the current Treasury Regulations, which were finalized on December 31, 2003, Taxpayers were required to expand, exceed or refine the knowledge in the industry. The "technological in nature" test requires that the research fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science.

This ruling is relevant because the years in question were 1994 & 1995, prior to the issuance of the regulations that broadened the definition of qualified research. 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 the new regulations.

In addition, this ruling may be relevant to Taxpayers who were unable to utilize 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 amount of additional credit these expenditures would yield, now considered to be eligible expenditures under the current regulations.

Design Uncertainty

In order for an activity to qualify for the Research Credit, Taxpayers must be seeking to eliminate uncertainty related to the development or improvement of a business component. Uncertainty exists if the information available to the Taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.

In regards to one of the research projects for which qualified research expenditures were claimed, the IRS argued that Union Carbide's additional qualified research activities were not eligible because the Taxpayer was certain that it could produce the business component. However, the Court properly ruled that Union Carbide met the requirement of IRC §41, despite the evidence that showed the Taxpayer was confident it could develop the business component.

This particular ruling will benefit Taxpayers under examination where the IRS erroneously asserts that Taxpayers are ineligible for the Research Credit when they were certain they could accomplish the 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 an Employees Wage between Qualified and Non-Qualified Activities

In substantiating its qualified wages, 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 Court found the testimony and attestation by the employees to the time spent on qualified research to be credible. However, the Court differentiated between expenditures that had been attested to and those that had not. The Court allowed the qualified wages that were supported by employee testimony, and it disallowed the expenditures that were not supported by employee testimony.

In fact, the only qualified research expenditures allowed by the Court were based upon oral testimony of the employees performing the qualified research activities.

This ruling may be the most consequential for Taxpayers under audit that relied upon time estimates in order to quantify its qualified wages in its claim. Thus, Taxpayers that did not contemporaneously record the amount of time spent on qualified research activities may still be eligible for the Research Credit.

Use of Estimates in Computing Qualified Research Expenditures in the Base Period

In attacking the base period documentation, the IRS argued that Union Carbide "relied upon estimates and assumptions for a large number of [activities]. [The IRS] argued that estimates are legally impermissible." In order to emphasize its point, the IRS argued that the expert witnesses'

calculation of qualified research expenditures is flawed, as it erroneously included expenditures that were not qualified expenditures.

The Court, in allowing the expert witnesses' calculation (with some agreed upon adjustments), states that "the two runs that [the Government] 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)." The Court stated, "we accept [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."

This ruling, seemingly gives Taxpayers more flexibility in calculating its base period qualified research expenditures. In addition, the ruling supports Taxpayers that do not know the exact amount of qualified expenditures during the base in accordance with the current Treasury Regulations. By utilizing contemporaneous documentation to corroborate *conservative* estimates, Taxpayers can substantiate their qualified research expenditures incurred in the base period.

CONCLUSION

While this case may not be considered a "Taxpayer victory" due to the amount of expenditures that were disallowed as qualified research expenditures in accordance with IRC §41, there are many concepts for which the Court ruled in Union Carbide's favor, thus creating opportunities for Taxpayers performing qualified research.

Taxpayers claiming the Research Credit should consult with their MPP&W representative as to how T.C. Memorandum 2009-50 might impact their past, current and future research credit claims.

For more information about the Research Credit, please contact **Michael Devereux II, Adam J. Herman, CPA/ABV/CFF, CVA, ASA** or **Douglas M. Mueller, CPA** today at (314) 862-2070. Or, e-mail mdevereux@mppw.com.

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