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"WINS OF CHANGE" FOR THE R&D TAX CREDIT

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The years 2009 and, quickly approaching, 2010 are likely to be viewed as momentous for the research and development tax credit. Many have argued that the R&D credit, as enacted by Congress under Internal Revenue Code Section 41, has numerous flaws that have limited its effectiveness. It was initiated as an opportunity to reward companies for conducting research in the United States and to fend off an ever-increasing shift of high-paying jobs overseas. In fact, at its core, the R&D credit functions much like a jobs credit since it rewards activities conducted in the United States. Many companies have had to weigh the credit's benefits against the burdens of implementing a process for capturing a credit that has never been permanent, is non-refundable and contains ambiguous statutory definitions. Furthermore, even after a company has created a detailed process to gather supporting documentation, there may be drawn out and potentially costly battles with the Internal Revenue Service over the ambiguous statutory definitions.

Still, since 1981 Congress has continued to extend and enhance the R&D credit. The credit has broad bipartisan support in an era when Congress appears to have divergent positions on almost every other issue. As evidence, this year the relatively new Alternative Simplified Credit rate is increasing to 14 percent. This edition of Tax Advisor Weekly explores potential legislative changes to the credit as well as recent important judicial decisions. Overall, these are constructive for taxpayers.

LEGISLATION: PERMANENCY OR AN EXTENSION?

There have been numerous complaints that because the credit is temporary in nature, its overall effectiveness has been significantly impeded. The R&D tax credit has been renewed numerous times since its original enactment under the Economic Recovery Act of 1981. Once again the credit is scheduled to expire at the end of 2009, leaving tax departments in limbo as to whether to commit the resources (internal or external) to track a benefit that may not exist in the future. The Obama administration, like many before it, wants to make the research credit permanent. With the President's ardent support, Congress may finally be willing to go along. On September 21, at Hudson Valley Community College in Troy, New York, the President stated:

"My budget finally makes the research and experimentation tax credit permanent. This is a tax credit that helps companies afford the often high costs of developing new ideas, new technologies, and new products...which often mean new jobs. And this tax incentive returns two dollars to the economy for every one dollar we spend. Time and again, I've heard from leaders...from Silicon Valley to the Tech Valley...about how important this is."

A number of bills addressing changes to the credit now exist in Congress. Among these are proposals to extend the credit for multiple years, to make the credit permanent and to increase the Alternative Simplified Credit (ASC) rate from 14 percent to 20 percent. Obviously the cost of a permanent or even an enhanced credit, and its effect on the growing federal deficit, will be a significant consideration when Congress finally acts on the legislation this fall.

JUDICIAL DECISIONS: THE COURTS PROVIDE CLARITY

As a result of vague and incomplete definitions in the Internal Revenue Code and accompanying regulations, R&D credit administration has been subject to inconsistent court decisions and continually changing guidance. This lack of clarity may have prevented companies from fully capturing their research tax credit in the past. Still, 2009 proved to be an important year for the credit in the courts. The issues decided incrementally provide clarity to the statutory definition of qualified research. The courts weighed in several times during 2009 and, as summarized below, have shed light on critical issues.

McFerrin

Taxpayers scored a major victory on appeal in *U.S. v. McFerrin*.[1] Arthur McFerrin was a chemical engineer who founded an S-corporation that manufactured specialty chemicals.

[1] U.S. v. McFerrin, 103 AFTR 2d 2009-2566, June 9, 2009.

The Fifth Circuit Court of Appeals vacated a prior district court ruling that denied McFerrin's claimed research credits. The district court had denied the credit claim on the grounds that McFerrin failed to meet the "discovery test," which the district court held required expanding or refining existing scientific principles and a high threshold of innovation (similar to the discovery test as defined in R&D regulations issued in 2001, but which has since been eliminated). However, the court of appeals confirmed that the "discovery test" was no longer applicable in determining qualified research under the regulations. Furthermore, the court applied the "Cohan Doctrine,"[2] stating that "if a qualified expense occurred, the court should estimate the allowable tax credit." Importantly, the decision also affirmed that a court should consider employee testimony and institutional knowledge in determining a fair estimate of the qualified expenses.

Union Carbide

In *Union Carbide v. Commissioner*, the tax court provided guidance in the form of a memorandum opinion.[3] The tax court awarded Union Carbide a minimal amount of its claim based upon the five largest research projects reviewed. Still, the decision provides a significant positive precedent for other taxpayers. The IRS has regularly opposed the use of "extrapolation" and "employee recollections" as a methodology to determine qualified research expenditures. This is despite legislative history criticizing unreasonable record-keeping requirements. Importantly, the tax court in *Union Carbide* accepted the validity of such methods. The tax court confirmed that taxpayers are entitled to determine a close approximation of qualified research activities and expenditures by oral testimony and interviews supported by documentary evidence.

Union Carbide also addressed the parameters of the "consistency rule," which requires taxpayers to consistently quantify qualified expenditures in their base period and credit years. In Union Carbide, the court found that the consistency rule could be applied at the legal entity level that is incurring the qualified activities and not at the control group level. Additionally, the court accepted the "re-creation" of the base period expenditures because the original records were not available.

Union Carbide also confirmed that qualified research can occur as part of the production process of goods for sale to customers. The tax court found that the production process improvements should be analyzed separately from new product research. The decision allowed direct costs incurred during qualified process improvement research to be claimed as qualified research expenditures. The court maintained that the research credit qualification tests should be applied separately to the improvement or development of a production process for a particular product. However, Union Carbide's attempt to include a portion of the production supply costs as qualifying research expenditures was rejected because the business component under development was a process, not a product.

Overall the *Union Carbide* decision is a win for taxpayers who may not be conducting new product research, but instead are improving their overall production processes. Still, taxpayers must continue to focus on properly documenting that their process improvement research meets the standards for qualification.

FedEx

Taxpayers scored a major victory in *FedEx Corp. v. United States*.[4] The Federal District Court in the Western District of Tennessee granted FedEx's motion for partial summary judgment related to the company's development of internal use software.

In January 2001, the IRS issued final regulations (2001 Final Regulations) that allowed a research credit for internal use software development where:

1. the software is innovative in that it intends to result in a reduction in cost, improvement in speed, or other improvements that are substantial and economically significant;
2. the software development involves significant economic risk; and
3. the software is not commercially available.

These regulations also include in the general definition of qualified research a "discovery test," requiring that any qualified research be undertaken to "obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering."[5]

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[2] Cohan v. Commissioner, 39 F. 2d 540 (2nd Cir. 1930).
[3] Union Carbide v. Commissioner, TC Memo. 2009-50.
[4] *FedEx Corp. v. United States*, 103 AFTR 2d 2009-2722 (W.D. Tenn. June 9, 2009).
[5] T.D. 8930, 66 Fed. Reg. 280 (Jan. 2, 2001).

Because of the controversy surrounding these final regulations, new proposed regulations were issued in December 2001 (2001 Proposed Regulations). The 2001 Proposed Regulations eliminated the discovery test and modified the high threshold of innovation test for internal use software, requiring that for software to be innovative, it must be "intended to be unique or novel."[6] This proposed change, and additional hurdle, to the innovation test was not adopted in the final regulations, issued in December 2003 (2003 Final Regulations). Instead, these new final regulations included no further guidance pertaining to internal use software, which was described as "reserved." However, the discovery test continued to be excluded from the 2003 Final Regulations.[7]

With the 2003 Final Regulations, the IRS published an Advanced Notice of Proposed Rulemaking which provided that taxpayers could continue to rely on the internal use software provisions of the 2001 Final Regulations or the 2001 Proposed Regulations until future guidance was issued. However, if a taxpayer relied on the 2001 Final Regulations, they would be required to apply the discovery test in those regulations.[8] Alternatively, if a taxpayer relied on the 2001 Proposed Regulations, there was a requirement for a higher threshold of innovation, though no discovery test requirement.

The district court held that FedEx could apply the internal use software tests established in the 2001 Final Regulations. And significantly, the district court also held that FedEx was not required to follow the 2001 Final Regulations "discovery test."

In *FedEx*, the district court reasoned that it would be contrary to the Treasury and IRS' stated intent in adopting the 2003 Final Regulations, as well as congressional intent, to require that a taxpayer be bound by the discovery test. The court's decision is significant for companies claiming the research credit for internal use software development activities. *FedEx* provides that a taxpayer may follow the favorable 2001 Final Regulations internal use software definitions without applying the "discovery test," which was eliminated in the subsequent 2001 Proposed Regulations and the 2003 Final Regulations.

Deere & Companies

In *Deere & Companies v. Commissioner*, through a summary judgment, the U.S. Tax Court required the inclusion of foreign branch gross receipts in the Alternative Incremental Research Credit (AIRC) method for calculating the research tax credit.[9] Deere conducted operations in Germany, Italy and Switzerland through branches. In computing the research credit, Deere excluded from its gross receipts all of the amounts from these foreign operations. The court ruled that, when claiming the AIRC under IRC Section 41(c)(4), the taxpayer is required to include in the calculation the amounts for each of the foreign branch operations. In a strict interpretation, the tax court concluded that neither the structure or the legislative history of IRC Section 41 nor the "historic domestic focus" of the credit for increasing research activities establishes that Congress intended to exclude the total annual gross receipts of a taxpayer's foreign branch operations from the computation under IRC Section (41)(c)(1)(B). The court did not address the situations where taxpayers conduct foreign operations through entities other than a branch.

Proctor & Gamble

The *Proctor & Gamble* case before the Federal District Court for the Southern District of Ohio, Western Division, is yet to be decided. Still, it is likely to affect the R&D credit landscape in 2010. The two primary R&D credit items at issue in Proctor & Gamble relate to patent expenditures and intra-company sales.

Proctor & Gamble, like many other corporations, conducts extensive R&D activities each year that require patent protection. In connection with its research activities, it maintains in-house attorneys and staff whose activities include research for, and preparation and completion of, patent applications, necessary exhibits, diagrams and textual discussion and analysis of related inventions. The IRS denied these "patent obtaining" amounts as qualified research expenditures. The court will likely have to determine to what extent the definition of qualified costs includes patent-related expenditures.[10]

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[6] REG-112991, 66 Fed. Reg. 66362 (Dec. 26, 2001).
[7] T.D. 9104, 69 Fed. Reg. 22.
[8] Advance Notice of Proposed Rulemaking (ANPR) 2004-9, 69 Fed. Reg. 43 (in the judgment, the FedEx Court referred to the ANPR as the "2004 Announcement").
[9] *Deere & Companies v. Commissioner*, 133 T.C. No. 11, (October 22, 2009).
[10] See also FSA 200131007 where patent costs were disallowed.

The second item at issue in *Proctor & Gamble* relates to the definition of "annual gross receipts." The IRS position is that annual gross receipts should include receipts from intra-company sales. Under the regular credit regime, a taxpayer is entitled to a credit equal to 20 percent of the excess of its qualified research expenditures for the tax year over a base amount. The base amount is then determined by multiplying the taxpayer's average annual gross receipts for the preceding four taxable years by a fixed-base percentage. Therefore, if the average prior four years' gross receipts are increased by including intra-company sales to foreign subsidiaries, the base amount will be increased and the resulting credit will be decreased (for those not subject to the 50 percent limitation). This issue has been a critical area of dispute between the IRS and taxpayers for a number of years given the imprecise language in the regulations.[11]

[11] See CCA 200233011 and CCA 200620023 for conflicting guidance.

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The President and Congress appear ready to, at a minimum, extend the R&D credit. However, until the statutory definition of "qualified research" is clarified by Congress, tax departments continue to seek certainty as to sustaining the amounts they have previously claimed. Furthermore, identifying research credit amended claims as a Tier 1 issue has put many taxpayers on the defensive in supporting their credit amounts.

On balance, 2009 offered taxpayers some good news. In recent decisions, the discovery test was repudiated, internal use software qualification tests were defined and the Cohan Doctrine was applied. Courts have sided with taxpayers in allowing both "reasonable" interpretations of guidance and "reasonable" methodologies for qualitative and quantitative documentation support. Going forward, these "wins of change" may offer taxpayers a more coherent path for sustaining R&D credits.

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