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THE REFERENCE

YOUR SPECIALTY TAX SOLUTION

IN DEFENSE OF R&E TAX CREDIT CLAIMS

As was well-publicized in 2007, the IRS released new audit directives to manage increased activity and interest surrounding the federal Research and Experimentation (R&E) credit over the last several years. In 2009, two critical court case decisions, Union Carbide Corporation & Subsidiaries v. Commissioner (T.C. Memo 2009-50) and United States v. McFerrin (570 F.3d 672), produced tax court decisions that provide further guidance and clarification regarding R&E tax credit claims. By combining the knowledge and insight gained from these new directives and tax court case decisions, taxpayers are well armed to develop and defend R&E tax credit claims.

R&E Credit Audit Examination Tactics

Concurrent with the new IRS focus on the R&E credit, the IRS tweaked Form 4564, the Information Document Request (IDR), which serves as the initial inquiry into a taxpayer's R&E credit calculation. This 19-question, standardized form reveals the IRS's strategy of trying to force a wedge or disconnect between the taxpayer's qualified research activities (QRAs) and its qualified research expenses (QREs.) Technically, if the IRS can prove that there is no relation between one's QRAs and QREs (at least to the extent satisfactory to the IRS), then the credit can be disallowed. The language and focus of Form 4654 promotes the IRS's favored project accounting method when determining QRAs and QREs as opposed to the more commonly used and GAAP-friendly departmental or activities accounting method.

IDR Form 4564 stresses investigation of and support for individual research projects (the creditable improved business components) as is technically required in the Code. However, the IRS must know that most U.S. companies, due to budget and other resource constraints, have a very difficult time tracking qualified expenses and specific employee research activities on an individual project basis. Research "department" expenses and time are natural products of U.S. GAAP reporting and consolidation procedure; it's usually extra, non-financial record keeping performed on the side by engineers and technicians that conform more squarely to the IRS's preferred project accounting method. Of course, not every company has the resources to perform the tracking of individual projects by engineers and technicians, but some are better than others. It is this disconnect that becomes the focus of the examination of a taxpayer's QRAs and is first revealed to the examining agent in the response to Form 4564.

> "The IRS means what it says when it comes to its new audit methodology. Our approach, supported by recent court decisions, is seeing consistent success in satisfying examiners and protecting clients' credits."
>
> – TJ Sponsel
> Director
> McGuire Sponsel

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To counter this, it is essential to redirect the IRS's focus away from its standard checklist and redirect the conversation toward spotlighting the valid documentation of QRAs that the taxpayer can produce. In other words, an effort must be made to move away from IRS's preferred project approach and begin substantiating the credit claim through the use of the activities approach. This, by the way, absolutely must be performed with contemporaneous documentation, something we can't stress enough to clients. Where contemporaneous documentation is lacking, extra measures must be taken to produce accurate and detailed personal interviews recorded on tape and in writing as well as individual activity questionnaires and project-specific questionnaires to supplement and strengthen the existing documentation.

R&E Credit Tax Court Opinions

The two significant tax court decisions from 2009 that have helped provide further R&E tax credit guidance ultimately help taxpayers better understand acceptable methods of qualifying and substantiating research activities. The first decision, Union Carbide Corporation & Subsidiaries v. Commissioner, produced an important memorandum decision on March 10, 2009. This tax court memorandum most notably permits the use of "close approximations", as determine by the "Cohan Rule" (Cohan v. Commissioner, 39 F.2d 540, 543-544), when qualifying and quantifying research activities. The second decision, United States v. McFerrin (570 F.3d 672), helped further define "qualified research" and a "process of experimentation" in a June 9, 2009, decision from the United States Court of Appeals for the Fifth District.

The Union Carbide tax court memorandum allowed the use of oral testimony and close approximations to sufficiently substantiate qualified research expenditures under the Cohan Rule. This memorandum supported the use of the Cohan Rule and provided the following insight into the R&E credit:

- Clarification of the Discovery Test, which previously required qualified research activity to involve discovering information far beyond the taxpayer's existing knowledge. The Union Carbide memorandum emphasizes that this test only necessitates qualified activity to involve an effort to discover technological information.

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- Activity relating to the development of the manufacturing method may be qualified, even if conducted after a product is ready for commercial production. However, efforts must be made to identify and separate production costs from qualified research costs.

- With regard to maintaining consistency when qualifying and quantifying research activities in the base years and the credit years, the consistency of the particular type of records is not required. Also, the consistency rule was determined to apply at the entity level – not the control group level – when the credit is computed and applied to an aggregate group of companies.

The original United States v. McFerrin case decision disallowed McFerrin's entire $472,092 R&E tax credit claim for tax year 1999 in an Oct. 31, 2005, ruling. The credit claim was rejected on grounds that trial and error was not an acceptable form of experimentation, qualified projects did not demonstrate a high level of innovation, QRAs did not expand or refine existing principles and insufficient project detail was provided. The credit was disallowed and McFerrin was forced to repay the original credit amount in addition to nearly $130,000 in interest.

The McFerrin district court decision, however, was overturned in the United States Fifth Circuit Appellate Court in June 2009. The appellate court determined that the original 2005 decision was based on the 2001 Proposed R&E Credit Regulations, not the new 2004 Final Regulations that should have taken precedence in the ruling. These new regulations provide the following guidelines for qualified activity:

- Discovery of new information does not need to be revolutionary. Rather, the discovery of new information must be intended to eliminate uncertainty regarding the development of a final product or process design, the taxpayer's ability to produce the design, the technique used to develop the product or process.

- Qualified experimentation can include systematic trial and error, virtual or physical simulations and modeling.

- Qualified activity must involve uncertainty during product or process development, identification of alternative solutions and an evaluation of alternatives.

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In Summary

In McGuire Sponsel's experience to date, tax examiners have not raised any immediate objections to reliance on personal interviews, detailed questionnaires or the proper utilization of the Cohan Rule supported by valid, contemporaneous documentation. Nor have they made any disparaging remarks regarding reliance on such procedures. We have settled full IRS examinations of clients' research credit claims without the IRS making any proposed adjustments by means of only submitting a detailed response to the IDR Form 4564 with supporting appendices attached comprised of the documentation discussed above. We state this not as a "chest-pounding moment" but to highlight the fact that the IRS expects credit calculations to be supported with reliable, contemporaneous documentation. Further, during a recent audit conducted by a state DOR, McGuire Sponsel came to the point where the auditor was not going to readily accept our calculated 2.24% base period percentage rate based on interviews, questionnaires and contemporaneous documentation for the base years. However, the auditor did have to conclude that based on the documentation presented, QREs and QRAs were established as a definite fact. McGuire Sponsel settled on a 3% base period percentage rate.

In summary, the IRS means what it says when it comes to the desire to see both project accounting and contemporaneous documentation in its new audit methodology. With a concerted effort to counter with an activities approach supported by the recent court decisions and inclusion of full employee participation in interviews and detailed questionnaires, McGuire Sponsel is seeing success in satisfying the examiners and protecting clients' research credits.