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Why U.S. Business Needs a Reliable Research Incentive

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Uncertainty surrounding the research and development tax credit continues as Congress failed to weigh in on its continuation.

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The research credit is an important incentive that helps the United States retain its leadership in technological innovation. Unfortunately, its benefit is hobbled by two principal types of uncertainty. First, the credit has not been made permanent. And, as noted in a November 2009 Government Accountability Office (GAO) report, administration of the credit by the Internal Revenue Service has raised questions as to whether a business will be able to successfully retain credits claimed on its tax return. For these two reasons, uncertainty remains.

In the 30 years since Congress enacted the country's first tax credit for research by businesses, it has been scheduled to sunset, or has lapsed and then been renewed, 13 different times. The credit has been widely recognized as one that encourages investment in innovations that produce economic as well as social benefits to the U.S., and has always enjoyed widespread bipartisan support.

But the U.S. research credit – one of the most generous research incentives in the world in 1980 when it was launched – has fallen to 23rd place among the 38 countries of the Organization for Economic Development and Co-operation (OECD) and the seven advanced

emerging countries. The U.S. now ranks eighth in private research and development expenditures as a share of economic output, according to OECD. For a variety of reasons, including the relatively low research credit rate, investments in high-paying research and innovation jobs are being made elsewhere in the world.

Jim Shanahan

Each time the U.S. research tax credit has been allowed to expire, domestic enterprises have struggled to adjust business plans and cope with the uncertainties that result from delays in recognizing tax benefits — this on top of the frequent contention between companies and the IRS over what expenses are creditable and under what circumstances. For many companies, the time and expense invested in defending their use of the credit erodes the credit's value, and creates for some a disincentive for further research and development on U.S. soil.

As of today, the credit has been allowed once again to sunset, and its fate is unclear, as no extension was enacted as of press time. In September, President Barack Obama called on Congress to make the credit permanent, proposing an increase to the simplified research credit rate from the current 14 percent to 17 percent. The White House acknowledged that these changes would likely cost $100 billion over the next 10 years, and emphasized that the credit is a boon to U.S. competitiveness in world markets and essential for creating jobs in this country.

Seven Areas of Contention

The U.S. business landscape today is far different that it was in 1981 when the credit was enacted. The decline of manufacturing, the explosion of the then-nascent technology sector into a major industry and the rapid developments in medicine, alternative energy and other areas call for an update to the research credit in order to reflect American industry today.

As mentioned, the GAO report on the design and administration of the credit identified seven areas of contention between the IRS and companies. In several important cases, courts have stepped in to provide additional guidance and have ruled in favor of companies on these seven important issues.

1. **Inconsistent document standards.** The GAO report noted that companies are burdened by inconsistent documentation standards (while also pointing out that establishing validity of credit claims is a daunting task for the IRS, as well). While U.S. Treasury regulations do not prescribe a specific record-keeping method that a company

must use to substantiate its entitlement to the research credit, the IRS has attempted to enforce stringent record-keeping standards. In some recent cases, courts have reaffirmed the legal standard for substantiation and have allowed a company, in the absence of certain contemporaneous records such as hours worked on a project, to use other evidence such as institutional knowledge and testimony of employees to estimate expenses on a reasonable basis.

2. **Nature and degree of improvements.** Lack of standards also has prompted disputes over the nature and degree of improvements that qualify for the credit, with the IRS in some cases saying research should result in a degree of innovation that "exceeds, expands or refines" the knowledge in a field — essentially, a higher standard than is called for in the Internal Revenue Code (IRC). Courts have held that a company only need discover information that eliminates technical uncertainty regarding the development of a business component, and that there is no standard relating to level of advancement.

3. **Inclusion of intercompany gross receipts.** Under the regular research credit computation method, a taxpayer's ability to claim the credit depends in part on the amount of gross receipts reported by the company in prior years. The IRS attempted to require companies to include intercompany gross receipts in these credit calculations, negatively impacting research credit benefit. In one case, the U.S. District Court sided with the taxpayer, finding that controlled-group members should be treated as a single taxpayer and that transfers between members of the group should be disregarded in calculating the credit. In another recent case, the government chose to concede this issue.

4. **Late-stage testing.** Companies and the IRS also have grappled over testing activities undertaken in the development of new or improved products and production processes. Companies have claimed the credit for testing done to eliminate uncertainty regarding product design, but the IRS has rejected this testing as qualified research, saying the tests were routine. Several court rulings have upheld companies' late-stage testing as qualified for the credit, focusing on whether the activity is intended to eliminate uncertainty and not on whether the test is routine.

5. **Definition of supplies.** Ambiguity still surrounds the definition of "supplies" used in R&D. The IRS has not permitted companies from designating as supplies any property that would be subject to depreciation, even if the company did not take depreciation allowances for the property, arguing that the constructed property is of the type that would be subject to depreciation if the entity had purchased it as a final product. However, the courts have rejected this IRS view and agreed that if supplies are purchased for use in research, the character of the property in the hands of the company is controlling, and thus research supplies that were purchased and resold could be included in the research credit calculation.

6. **Direct supervision or support.** The IRC provides that wages of employees who directly supervise or support qualified research activities count as qualified research expenses. The IRS often requires that a company claiming the credit for such wages prove that each separate cost element is, in and of itself, a qualified research expense, instead of whether the cost element is incurred with respect to research. This is an important distinction, which courts have resolved in favor of companies. In one case, a court allowed all costs of a project to qualify, concluding that the activities should be

examined in *toto*, rather than separately, since the activities were interdependent and built on each other, while separately the activities were of no utility.

7. **Internal-use software.** Equally vexing has been the issue of defining what constitutes internal-use software (IUS). In the absence of a final regulation, the IRS has declared that development of software for a company's own use fails to qualify for the research credit unless it meets a set of standards contained in regulations – regulations that had since been discarded. Companies argued that, especially in certain industries, there is no meaningful distinction between IUS and other software development and that, in the absence of final regulations taxpayers should be able to draw guidance from subsequent final regulations as well as congressional intent indicated in committee reports. One court has sided with the companies and appeared to be especially concerned with enforcing an IRS position that, according to Treasury's and the IRS's own words, would disregard final regulations that "prescribe the proper treatment of the expenditures they address."

Momentum is growing that favors making the research credit permanent. Research credit issues are complex, and some may always be so. The GAO's recommendations, and the guidance provided by the courts, provide a useful roadmap for Congress as it seeks to ensure fairness while continuing to support the innovation of U.S. companies.

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