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# WNTS Insight

A Washington National Tax Services (WNTS)  
Publication

July 26, 2011

## *IRS restrictions on research credit elections might lead to 'Mayo' review*

Recently published final research credit regulations retain provisions from 2008 proposed regulations relating to the election of the alternative simplified credit (ASC) under section 41(c)(5) that taxpayers and practitioners had criticized as overly restrictive. If a taxpayer were to challenge the validity of those provisions in court, the Supreme Court's decision in *Mayo* earlier this year presumably would be applied in reviewing the regulations.

Under the contested provisions of the final regulations, (1) an extension of time to make or revoke an ASC election under section 41(c)(5) will not be granted under Reg. sec. 301.9100-3 ("9100 relief") and (2) ASC elections may not be made or revoked on an amended return.

### Background

#### *Proposed ASC regulations*

The ASC was enacted, as part of the Tax Relief and Health Care Act of 2006, to make the research credit more widely available. Under the ASC, taxpayers calculate the credit by reference to their research expenditures for the preceding three years; by contrast, the regular incremental research credit generally references a base amount of research expenditures from 1984-1988. The applicable provisions of the tax code (section 41(c)(5)) do not include any restrictions on when a taxpayer may elect the ASC.



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In 2008, the IRS issued proposed and temporary regulations to provide guidance on election and calculation of the ASC. The 2008 regulations contained election procedures identical to those for the since-repealed alternative incremental research credit (AIRC), i.e., an ASC election or revocation of an ASC election must be made on a timely filed (including extensions) return and may not be made on an amended return. The 2008 regulations further provided that the IRS would not grant 9100 relief for taxpayers to make or revoke ASC elections.

Commentators criticized these provisions of the proposed regulations as excessively restrictive and contrary to Congress's intent to make the research credit more widely available. For example, PwC partner Jim Shanahan said at an IRS hearing on the proposed regulations that the power to grant 9100 relief "should be exercised in a manner that is reasonable and does not deny tax benefits that are clearly allowed by statute." The ban on 9100 relief, he said, is "unduly restrictive and does not implement the new ASC in a reasonable manner. The regulations do not conform with the IRS's long-standing policy of permitting relief from regulatory deadlines in those limited circumstances where [the section] 9100 regulations deem relief to be warranted." That policy -- as set forth in the preamble to the 9100 relief regulations -- includes "permitting taxpayers that are in reasonable compliance with the tax laws to minimize their tax liabilities by collecting from them only the amount of tax they would have paid if they had been fully informed and well-advised," he said.

As justification for the election provisions in the final regulations, the IRS states that "tax administration and fairness are best served by adopting the same election procedures for the ASC that are used for the AIRC." The IRS did not provide any further rationale for the procedures adopted in recent regulations with respect to the AIRC.

### ***Judicial review of regulations***

In *Mayo Foundation for Medical Education and Research v. United States (Mayo)*, the Supreme Court concluded that the proper standard of deference when reviewing Treasury regulations is the highly deferential *Chevron* standard, rather than the less deferential *National Muffler* standard.

The *Chevron* standard, announced in the Supreme Court's 1984 decision in *Chevron USA Inc. v. Natural Resources Defense Council*, employs a two-part framework in analyzing the deference to be given to agency rules. First, a court is to determine whether Congress directly addressed the precise issue. If so, the court, and the agency, must give effect to the unambiguously expressed intent of Congress. If Congress has not directly addressed that precise issue, regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Thus, a court may not substitute its own construction of a statutory provision for the agency's reasonable interpretation of the statute. (For discussion of *Mayo*, see WNTS Insight, "[Supreme Court decision addresses deference accorded tax regulations](#)," March 2, 2011.)

Following release of the *Mayo* decision, many observers stated their belief that it would be more difficult for taxpayers to challenge the validity of tax regulations.

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## Potential applicability of *Chevron/Mayo* to the final ASC election rules

### *Chevron* step one

Step one of the *Chevron* analysis asks whether Congress directly addressed the precise issue. In this case, since the statute is silent about procedures for electing the ASC, the answer seems to be "no"; hence, a court reviewing the regulations would proceed to *Chevron* step two.

**Observations:** Nevertheless, a taxpayer might argue that the step one analysis should take into account the "audible silence" approach taken by the Tax Court in reviewing the validity of certain regulations. Such an argument would proceed by asserting that in light of Congress's statutory imposition of strict time limits on elections in another research credit provision (section 280C, discussed below), the fact that Congress did not explicitly impose such limits when enacting the ASC may indicate an intent that a strict rule should not apply. Presumably, Congress is aware that generally the 9100 regulations are available to allow late elections in reasonable circumstances, and there was no indication that Congress believed that these rules would not be appropriate for this election.

The Tax Court's "audible silence" approach was expressed in the court's 2009 decision in *Lantz v. Commissioner*, dealing with regulations imposing limits on innocent spouse relief under section 6015(f); the court has since followed that approach in several similar cases. Said the court, "We find that by explicitly creating a 2-year limitation in subsections (b) and (c) but not subsection (f), Congress has 'spoken' by its audible silence." **Note:** The Tax Court's "audible silence" approach has been rejected by three circuit courts of appeal in the context of innocent spouse relief.

### *Chevron* step two

*Chevron* step two asks whether the regulations at issue are "arbitrary, capricious, or manifestly contrary to" the statute.

Congress added the ASC to the tax code to make the research credit more accessible to taxpayers. The ASC was added to other approaches for calculating the credit, and Congress clearly intended that a taxpayer should be able to choose the one providing the greatest benefit in its situation. However, the final regulations, by limiting when taxpayers can elect the ASC, make the credit less accessible to taxpayers. The research for which a credit is being claimed has already occurred; the election relates only to the method the taxpayer will use to claim the credit -- regular credit or ASC. There does not appear to be any Congressional intention to limit this method choice to any particular time.

Congress has imposed strict, clear time limits on another election related to the research credit: "An election under this paragraph for any taxable year shall be made not later than the time for filing the return of tax for such year (including extensions), shall be made on such return, and shall be made in such manner as the Secretary may prescribe. Such an election, once made, shall be irrevocable." (Section 280C(3)(c)).

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Since Congress did not impose any such restrictions on the ASC election, some commentators have questioned why the IRS did so, such that an inadvertent failure to make the election on an original return cannot be corrected. The IRS has not explained its decision beyond the "fairness and tax administration" rationale noted above.

In its 2006 decision in *Vines v. Commissioner*, the Tax Court noted the policies behind Reg. sec. 301.9100, as stated in the preamble to those regulations -- as quoted by Jim Shanahan at the hearing on the proposed ASC regulations. The court observed that this view had been endorsed by then-Treasury official (and current PwC partner) Annette Smith at a 1996 hearing on the temporary and proposed 9100 regulations:

I would agree that the 9100 policy should be to try to put a taxpayer back in the same position they would have been had they made a timely election, and I think that policy's based on the fact that there can be significant consequences to a taxpayer who's qualified to make an election and fails to make it timely.

The IRS has not explained why this reasonable administrative policy should not apply with respect to electing the ASC.

**Note:** At a recent meeting of the American Bar Association Section of Taxation in Washington, Tax Court Judge Mark V. Holmes discussed various administrative law doctrines that taxpayers could use to challenge the validity of regulations subsequent to the *Mayo* decision.

For example, Judge Holmes referred to the *Chenery* rule, under which "a reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency. If those grounds are inadequate or improper, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate or proper basis. To do so would propel the court into the domain which Congress has set aside exclusively for the administrative agency." *SEC v. Chenery Corp.*, 332 U.S. 194 at 197 (1947).

**Observation:** A taxpayer choosing to challenge the validity of the ASC election regulations might argue that the stated rationale for the strict limitation on ASC elections (1) does not adequately explain how the regulations are consistent with the clear policy behind enactment of the ASC, (2) does not make sense in light of the fact that the AIRC has been repealed since the ASC regulations were proposed, (3) and does not distinguish this election from other elections for which 9100 relief is possible. While there might be another, more cogent reason to distinguish this election from the other myriad elections for which 9100 relief is possible, a reviewing court that strictly followed the *Chenery* rule should hold the IRS to "the grounds invoked by the agency."

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*For more information, please do not hesitate to contact:*

*Jim Shanahan            (202) 414-1684            jim.shanahan@us.pwc.com*

*Dan Wiles                (202) 414-4586            dan.wiles@us.pwc.com*

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