

WNTS Insight

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Second Circuit examines eligibility of supplies for research credit

In brief

The US Court of Appeals for the Second Circuit has affirmed a Tax Court decision denying Union Carbide Corporation (UCC) a research credit under section 41 for the cost of certain supplies, agreeing with the Tax Court that the taxpayer was entitled to a credit only for supplies used to perform research, not for the cost of supplies that would have been used regardless of any research performed.

Note: The supplies issue was just one aspect of the Tax Court's 298-page opinion, which addressed many important issues related to the research credit. For prior discussion, see WNTS Insight, "[Union Carbide: Tax Court rejects many adverse IRS 'legacy positions' on research credit](#)," May 21, 2009.

What did the Tax Court decide?

Section 41(b)(2)(A)(ii) defines "qualified research expenses" to include "any amount paid or incurred for supplies used in the conduct of qualified research."

This appeal involved UCC's claim for research credits relating to the cost of supplies used in two research projects conducted by the company during 1994 and 1995 -- the Amoco anticoking project and the UCAT-J project. The Second Circuit noted that "the Tax Court judge held, and it is not disputed here, that UCC's Amoco anticoking and UCAT-J projects were qualified research."

The issue addressed by the Tax Court, and then the Second Circuit, is whether the cost of supplies used by UCC during the two projects that would have been used in the manufacturing process regardless of whether research was performed qualifies as an "amount paid or incurred for supplies used in the conduct of qualified research."



The Tax Court concluded that the costs of these supplies were incurred in the production of goods for sale, not in the conduct of qualified research, and therefore were not eligible for the credit. The court said that these costs were "at best, indirect research costs excluded from the definition of [qualified research expenses]" under the applicable Treasury regulations. UCC appealed from this aspect of the Tax Court's decision.

How did the Second Circuit interpret ambiguous regulations?

Relying on a dictionary definition of the word "use," UCC argued that under the "plain language" of section 41, it was entitled to the cost of all supplies "used in the conduct of qualified research" -- both "supplies that it would not have purchased absent any research *and* for supplies that it would have purchased in any event and that were used to make a product for sale." [emphasis in original]

The Second Circuit rejected this argument for two reasons. First, citing several cases including the Supreme Court's *Mayo* decision, the court noted that "the dictionary definition of a particular word does not necessarily constitute the beginning and end of statutory construction."

Next, the court explained that its task "is to determine whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case." However, instead of focusing only on the word "used" as UCC did, the court looked at the meaning of the phrase as a whole -- the critical part being "...in the conduct of qualified research" -- and stated that "At first blush, this suggests that the statute only covers costs for supplies purchased for the purpose of conducting qualified research. Indeed, until we considered UCC's argument, it would not have occurred to us that this credit applies to costs of supplies that UCC would have purchased and used in any event."

The Second Circuit further noted that the phrase "supplies used in the conduct of qualified research" appears in a code section (41) titled "Credit for increasing researching activities," suggesting that supplies used in the ordinary course for producing goods for sale were not to be considered eligible for the credit.

The Second Circuit therefore agreed with the Tax Court that the costs for which UCC was seeking a credit are "at best, indirect research costs excluded from the definition of [qualified research expenses] under" the regulations. However, the appeals court noted, the regulations do not clearly resolve whether the supplies were "used in the conduct of qualified research" because they do not make clear how to distinguish between direct and indirect research expenses.

The IRS argued in its brief that the costs of supplies are "'indirect research costs' if they would have been incurred regardless of any research activities." Because the IRS interpretation does not fall within any of the enunciated categories of interpretation of an ambiguous regulation for which the court would withhold deference, and because the interpretation is "entirely consistent with the purpose of the research tax credit," the Second Circuit accepted the IRS interpretation, declaring it "a result that is rational, prudent, and consistent with the legislative history and congressional purpose."

The Second Circuit therefore affirmed the Tax Court decision with respect to the denial of research credits for the cost of supplies used in the anticoking and UCAT-J

projects that would have been used regardless of whether any research was performed.

Note: In addition to addressing the treatment of supplies under the statute as well as in case law, the Second Circuit provided considerable analysis of congressional intent regarding what, and when, incentives are available to taxpayers, as part of its interpretation of section 41.

Observations

The facts of this case are distinguishable from a situation in which the final product that is the result of the process improvements is not yet created. Thus the *UCC* decision might not be followed by courts in analyzing credit eligibility of supplies for research related to both process and product uncertainty.

A noteworthy aspect of the Second Circuit opinion is the deference the court gives to the IRS interpretation of the statute and regulations. The majority found that the IRS interpretation of the statute was correct. The concurring judge remarked that if Congress sought to allow for the supplies to be creditable under a UCC-type fact pattern, the statute as written does not clearly support that interpretation. The IRS likely will argue in future cases that even under different facts involving use of supplies, the Second Circuit opinion indicates that deference should be given to the IRS interpretations of section 41.

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