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District court addresses use of statistical sampling to document business components in research credit case

In ruling on a case management/protective order, the U.S. District Court for the Western District of Pennsylvania recently turned down the taxpayer's request that the U.S. government be limited to statistical sampling with respect to documentation of business components in litigation over the taxpayer's research credit claim.

In a case covering tax years 1990 through 2006, Bayer Corporation (Bayer) sought to limit the government's discovery request for documentation on qualifying business components to a statistical sample. Bayer also asked the court to limit the evidence evaluated during the trial to those sampled items. The government objected, claiming it could not evaluate whether a statistical sample would be appropriate and sufficient before Bayer provided evidence of the qualification of its business components for the research credit.

The court held for the government, concluding that while statistical sampling and other estimation methods long have been considered acceptable methods for determining the characteristics of a large universe, there is no precedent for sampling to be forced upon the government in the liability phase of a trial. The court further noted that the government did not believe Bayer was capable of meeting its burden of identifying the business components for which the credits were claimed and that Bayer first needed to satisfy this burden before quantifying the credits.

Background

As reported in the decision, Bayer has more than 20,000 employees in the United States. It has divisions that focus on healthcare, materials science, and crop science.



Bayer, which is headquartered in Pittsburgh, conducts research activities at numerous sites throughout the United States.

Bayer does not account for research expenses by individual projects, but rather uses cost center accounting. In addition to accounting records, Bayer substantiates qualified research expenditures (QREs) for the purpose of claiming research tax credits "with internal status reports, emails, correspondence with federal agencies, EXCEL files, Word documents, Power Point presentations, access databases, lab notebooks, patent applications, and standardized and centrally maintained personnel and payroll records. Bayer also substantiates QREs through evidence provided by the employees and former employees who performed the research."

In 1997, Bayer retained Deloitte & Touche LLP to determine whether it was claiming all the research credits to which it was entitled. At the time, the IRS had completed its examination of Bayer's research credits for 1990 through 1994 and had reached an agreement on those years with Bayer. In 1998, Bayer filed a claim based on the Deloitte review for additional credits for all open tax years, which included 1990 to 1997. The IRS denied Bayer's claim for additional credits for the open tax years, and also denied the credits that previously had been agreed upon for the 1990-94 period.

Litigation

Bayer sued for a refund of \$49 million following the denial of credits. The government denied the claim and countersued for \$80 million, plus \$13 million of interest.

During discovery in 2010, the government asked Bayer to "[i]dentify and describe each new or improved business component Bayer contends it incurred qualified research expenses to develop during the credit years." In response to the government's demand for all documents, Bayer sought agreement on a fixed and final sampling plan up front, with no further document discovery until it was agreed to by the parties. Bayer estimated that it had developed more than 100,000 business components during the period covered. Bayer stated that its books and records did not, and are not, required to track these business components individually. Bayer therefore sought to use statistical sampling to develop its response.

Bayer's arguments largely were based on the burden and complexity of collecting the necessary information, and the fact that both the IRS and the courts have allowed the use of statistical sampling. Bayer described the scope of the documentation issue as follows: "During the years at issue, Bayer's research spending exceeded \$6 billion at 49 separate sites across the country. The research was performed by tens of thousands of individual Bayer employees. It consisted of millions of individual expenditures that were charged to more than 1300 cost centers. The vast scope of this enterprise is illustrated by the fact that Bayer has already collected more than one billion (1,000,000,000) pages of electronic records that are potentially relevant to its claims from just four of the forty-nine sites at issue and has already turned over more than 3 million pages of responsive documents to the government."

After describing the burden of collecting records at five of the largest of Bayer's 49 locations, the total cost of which was \$3.6 million, Bayer claimed that it would take decades to collect all the documents necessary to substantiate the QREs.

The government argued that Bayer first was required to demonstrate that it could meet its burden of identifying the business components for which the credits were claimed. Until this burden is satisfied, according to the government, quantifying the amount of credits to which Bayer is entitled is premature. The government further

argued that the court cannot require the government to accept the results of a statistical sample as the sole evidence to be considered.

Decision

The District Court held for the government and declined to impose the use of statistical sampling. While Bayer had demonstrated that the identification of each business component was burdensome, the court found the burden was not undue relative to the benefit. Further, the court determined that to allow Bayer to document some business components at only eight of its 49 research locations would be to "reward" Bayer for its failure to keep evidence.

In reviewing relevant case law, the court found that sampling had been used (a) when opposing parties agreed on a plan, (b) when other evidence could be used to rebut the result, (c) in the damages phase of a trial following the determination that a liability existed, or (d) to resolve treatment of sampled items, with remaining items to be addressed following the trial. Each of the cases reviewed were found to be distinguishable from Bayer's case.

Observations

The core issue in the case concerns documentation of business components for research credit purposes that Bayer had not previously developed. Bayer sought not to provide any documentation before the applicability of its proposed sampling plan was considered.

While both the government and Bayer retained statistical experts, each of whom developed statistical sampling plans, the issue of how statistical sampling should be done and whether Bayer's proposed plan was acceptable did not enter into the court's decision. As a result, the decision does not address statistical methodology.

The use of statistical sampling became an issue only because there was no agreement between the government and Bayer. Had the parties agreed on a method, the court would not have had to decide the issue.

This case warrants further monitoring. Given the complexity of the facts, it would not be surprising for some compromise to be reached, and especially for sampling to be considered, if Bayer first demonstrates that some research credits are allowable.

Because the use of statistical sampling can be in the mutual interests of taxpayers and the IRS, we expect that existing statistical sampling guidance (see Rev. Proc. 2011-42) will continue to be an acceptable approach for use by both taxpayers and agents -- not only for research credit computations, but as a general methodology.

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Note: Standards for the substantiation of QREs that can be built upon cost center accounting systems will be a critical discussion topic at PwC's 2nd Annual Global R&D Tax Symposium: Fostering Innovation in the United States and Around the World, to be held May 10 in Washington, DC. To learn more and register for the Symposium, please visit:

<http://www.meetpwc.com/rsvp/invitation/invitation.asp?id=/m2c53c-4PY6BE6H7NDER>.

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