WNTS Insight

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New IRS/Treasury "business plan" calls for important research credit guidance

In brief

According to the 2012-2013 IRS/Treasury priority guidance plan (commonly known as the business plan) released yesterday, the government is working on guidance to address three important and long-standing topics related to the section 41 research credit:

- Regulations on the exception from the definition of "qualified research" for internal-use software under section 41(d)(4)(E);
- Regulations on whether the gross receipts component of the research credit computation for a controlled group under section 41(f) includes gross receipts from transactions between group members; and
- Guidance on the treatment of research expenses incurred in making prototypes that may be used in a taxpayer's trade or business or be held for sale.

This WNTS Insight will examine the key issues this forthcoming guidance is likely to address.

Internal-use software

Key issue

Regulations on the exception from the definition of "qualified research" for internal-use software under section 41(d)(4)(E) have been on the IRS/Treasury business plan for several years. As noted in a June 2012 Joint Committee on Taxation staff (JCT) analysis of Obama Administration revenue proposals, several definitional issues

affect the administrability of the research credit, including the definition of internal-use software. The JCT states, "The uncertainty as to the availability of the research credit for the development of internal-use software may shift investment away from such research to other research which it is clear is eligible for the credit. Such a shift may not represent the efficient allocation of research funding."

Prior guidance

FedEx: In an order granting FedEx Corporation's motion for partial summary judgment on the legal standards for research credit claims, the US District Court for the Western District of Tennessee in 2009 held that FedEx may rely on the revised definition of the discovery test set forth in final section 41 regulations issued in 2003. This revised definition eliminated the requirement that qualified research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.

The district court then held that FedEx may rely on the "internal-use software" test set forth in earlier final regulations issued in 2001 because the later final regulations did not revise that test as enunciated in 2001. The district court declined to follow a 2004 IRS Announcement that would apply the older, more stringent "discovery" test to internal-use software.

For prior discussion of the *FedEx* decision, see WNTS Insight, "Stringent research credit test held not to apply to internal-use software," June 11, 2009.

Observations

As exemplified by the *FedEx* decision and the JCT discussion, there is a clear need for formal guidance regarding internal-use software; informal guidance like the 2004 Announcement has not resolved the issue.

Intercompany gross receipts

Key issue

Regulations on whether the gross receipts component of the research credit computation for a controlled group under section 41(f) includes gross receipts from transactions between group members have been on the IRS/Treasury business plan for several years.

As described below, the IRS and the courts have been struggling with this issue since final regulations defining gross receipts were issued in 2001

Prior guidance

Final regulations: The final regulations issued in 2001 defined gross receipts as "the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from all its activities and from all sources (e.g., revenues derived from the sale of inventory before reduction for cost of goods sold)."

Chief Counsel Advice: In CCA 200233011, the IRS concluded that taxpayers could exclude from the calculation of gross receipts payments -- such as royalties and sales proceeds -- from controlled foreign corporations (CFCs) because those entities are part of the "single taxpayer." Taxpayers agreed with this CCA.

During 2005, taxpayers repatriated billions of dollars from their CFCs under section 965, which had been enacted as part of the American Jobs Creation Act of 2004.

Under the 2002 CCA, section 965 dividends could be excluded from the gross receipts calculation.

In 2006, however, the IRS reversed course. In CCA 200620023, the IRS took an opposing position and concluded -- but based on sketchy facts and unclear reasoning -- that receipts from CFCs, which would include section 965 dividends, should be included in the gross receipts portion of the regular research credit computation.

IRS settlement guidelines: The IRS Appeals division in June 2010 issued Appeals settlement guidelines (ASG) regarding "whether a domestic corporation ('taxpayer') and its majority-owned subsidiaries must include receipts from foreign affiliates in determining the controlled group's aggregate gross receipts for purposes of computing the research credit 'base amount' under Internal Revenue Code (I.R.C.) § 41(c)(1)." ***Note:*** Details of the actual settlement guidelines and discussion of the government's hazards of litigation were redacted from the publicly available ASG document.

For discussion of the ASG, including background on the legal issue, see WNTS Insight, *"IRS Appeals releases redacted settlement guidelines on research credit gross receipts issue,"* June 21, 2010.

Procter & Gamble (P&G): In a significant taxpayer victory just a few days after the IRS released the ASG, the US District Court for the Southern District of Ohio on June 25, 2010, granted P&G's motion for partial summary judgment (and denied the IRS's cross-motion on the same issue) that Procter & Gamble correctly had excluded intercompany transaction receipts from foreign members of its controlled group in determining its gross receipts for purposes of calculating its section 41 research tax credit for the years 2001-2005.

Observation: The *P&G* decision would appear to have increased the IRS's hazards of litigation on the issue.

For discussion of the *P&G* decision, see WNTS Insight, *"Court rules that taxpayer correctly excluded receipts from foreign subsidiaries in calculating research credit,"* June 30, 2010.

Hewlett-Packard (HP): In the most recent development regarding this issue, the US Tax Court on September 24, 2012, issued its decision on the parties' motions for partial summary judgment in *Hewlett-Packard v. Commissioner,* in which the issue before the court was whether Hewlett-Packard was required to include nonsales receipts in its "average annual gross receipts" for purposes of calculating its section 41 research credit for tax years 1999-2001.

The most important aspect of the decision is the court's acceptance of the government's concession that the taxpayer could exclude from "gross receipts" intercompany gross receipts received from CFCs from its calculation of gross receipts for the years at issue.

Another aspect of the decision is that the court did not accept the taxpayer's narrow definition of gross receipts as limited to sales receipts, concluding that the term also encompasses nonsales receipts reflected on Form 1120, lines 4 (dividends), 5 (interest), 6 (gross rents), 7 (gross royalty), and 10 (other income) for purposes of the research credit calculation.

Note also that the court did not accept the taxpayer's suggestion that the government's position represents an impermissible retroactive application of the

final regulations at Reg. sec. 1.41-3, which include a broad definition of gross receipts but apply to tax years after the years at issue in this case. The court said it believes that the Treasury/IRS logic in "embracing" a broad definition of gross receipts for section 41 purposes, as expressed in the preamble to the final regulations, applies equally to earlier years as well. The court found that the legislative history indicates that Congress also "embraced" a broad definition of the term.

Observations

The government's concession in the *HP* case would appear to indicate that the IRS has abandoned the position it took in the 2006 CCA.

Prototype expenses

Key issue

The new IRS/Treasury business plan includes "Regulations under §174 concerning inventory property." This is the third of the research-related issues the government now plans to address.

As explained in the recent JCT analysis of Obama Administration revenue proposals, "Taxpayers and the IRS disagree as to whether the cost of supplies used in constructing tangible property such as molds and prototypes, where such items are held for sale by the taxpayer, are eligible for the research credit." The JCT report states that the definition of supplies in general is one of the main definitional issues affecting the administrability of the research credit.

Prior guidance

TG Missouri: In a significant win for taxpayers, the US Tax Court, reversing an IRS determination, held in 2009 that a significant amount of research and development supplies (molds for automotive parts) that a parts supplier purchased from a toolmaker and later resold to the parts supplier's customer, an equipment manufacturer, may be included in the taxpayer's research credit calculation. For prior discussion, see WNTS Insight, "*Purchased and resold supplies may qualify for the research credit, Tax Court holds*," November 17, 2009.

Trinity Industries: In a taxpayer-favorable decision from early 2010, the U.S. District Court for the Northern District of Texas held that substantial portions of the wages, supplies, and contract research costs involved in developing, testing, and building certain prototype ships were qualified research and development expenses for purposes of the research credit. For prior discussion, see WNTS Insight, "*Research credit allowed for prototypes designed and built under contract*," February 15, 2010.

Union Carbide: Most recently, the US Court of Appeals for the Second Circuit affirmed a Tax Court decision denying Union Carbide Corporation 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. For prior discussion, see WNTS Insight, "*Second Circuit examines eligibility of supplies for research credit*," September 18, 2012.

Observations

Because of the great variety of fact patterns that can arise with regard to supplies for which research credits are claimed, the IRS could eliminate many disputes with taxpayers by drafting broadly applicable, clear regulations addressing the credit-eligibility of supplies, including those used in constructing prototypes. Regulations addressing prototypes would resolve disputes in only a limited set of situations.

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Webcast

On Tuesday, November 27, PwC will host a webcast entitled "The research tax credit - Prospects for extension and key recent developments." The webcast will address forthcoming guidance and many other important research credit issues, such as the likelihood that the credit will be extended during the upcoming "lame-duck" session of Congress. To register for this important webcast, please click here.

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